

GEORGIA MARKET REFORM AND AGRICULTURE ASSESSMENT

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GEORGIA MARKET REFORM AND AGRICULTURE ASSESSMENT

I. Executive Summary

A. Background

USAID/Georgia's market reform program has reached a key turning point. Since its violent emergence from 70 years of Soviet rule in the early 1990s, Georgia has experienced significant success in developing the basic infrastructure for a strong private sector, including land titling, capital market development, and enterprise privatization. As a result, modest economic growth continues (at around 4.5 percent per annum so far in 2000).

Here was the country I had grown so much to like, with its wild mountain dances, devil-may-care dramas, prising open the fist of stone fixed around itself for 70 years only to find it shattering. In its place out burst a thousand small fists and dances. Waving and shouting louder than any before.

- Peter Nasmyth, from Georgia in the Mountains of Poetry

However, the Georgian Government is also in an unprecedented state of fiscal crisis fueled by the country's endemic corruption. Furthermore, this fiscal crisis is aggravated by Georgia's skewed distribution of income (among the highest in the world) and isolation from international trade (with merchandise trade at only 10 percent of purchasing power parity GDP).

Aggressive policy and regulatory reforms are a vital, but not sufficient, means of breaking this vicious cycle. Growth must bring economic opportunity to more than the privileged few. Local and foreign investors must overcome prohibitively high information and transactions costs to establish efficient market and value "chains" along which primary producers, suppliers, processors and traders can operate reliably.

USAID now has the opportunity to protect (and in fact significantly amplify) the gains from reform realized so far. It can do so by promoting, in a limited set of promising industry areas, direct outreach to firms and inducements to establish competitive, forward- and backward-linked, industry clusters that can expand Georgia's domestic and export earnings.

Perceiving this window of opportunity, USAID/Georgia saw this assessment as an occasion to gather both Mission staff and their key "virtual" team members from the Europe and Eurasia Bureau's Market Transition Office (E&E/MT) to evaluate the program and its ability to capitalize on this evolving situation. The team, comprised of E&E/MT specialists in the macroeconomic, financial, enterprise and land privatization, agricultural/agribusiness and micro/small-medium enterprise areas, collaborated closely with USAID/Georgia's Economic Reform Strategic Objective Team in preparing this report. The team was repeatedly urged to consider any aspect of the existing program as open to question. As a result, the assessment team believes that this report offers a set of suggestions from which the Mission could further focus, and in some instances redirect, the program to take maximum advantage of the opportunities now inherent in Georgia's relatively dire – yet promising – current situation.

In summary, the time appears propitious for a dual thrust in USAID/Georgia's economic reform program:

- First, **focus, concentrate and selectively accelerate the pace of reform** (particularly in the fiscal and government restructuring areas).
- Second, **create more vibrant markets for both land and agricultural products** in order to enable the nation's considerable agribusiness potential to respond to the gradually improving business/economic climate.

B. Summary of Recommendations

Three key adjustments to the USAID/Georgia economic reform program emerge from the team's findings:

1. **Strengthen fiscal reform** by enhancing the existing, tax administration reforms with further efforts aimed at:
 - a. continuing legal drafting efforts to simplify the tax code and to amend the tax code;
 - b. considering exempting agriculture and agricultural inputs from most of the many layers of taxation that present a particular deterrent to foreign and domestic investment in this key sector;
 - c. seeking targets of opportunity to control public expenditures more effectively; and effectively creating and administering a Treasury function in the Government that separates the payment of government officials from any subjective government budgeting;
 - d. completing efforts at internal control within the Tax Ministry and the Large Taxpayer Inspectorate; and
 - e. exploring means to restructure radically the deeply flawed customs service.
2. **Initiate corporate strengthening** by concentrating and furthering initial efforts at market reform from basic corporate functions to integrated and viable enterprise performance. This will occur through the institution of International Accounting Standards and by providing assistance from newly established structures to a more integrated effort aimed at assisting market-oriented enterprises. These efforts will evolve institutional development in Georgia from the past two years into a hybrid approach to provide:
 - a. local consulting to enterprises to develop good financial cost and management reporting and disclosure practices;
 - b. marketing research and enterprise business planning that will provide for periodic reporting and enterprise disclosure of annual reports and quarterly statements that are independently audited;
 - c. assistance in financial and physical plant restructuring of enterprises and tax forgiveness of

pre-market reform era obligations;

- d. establishment of investment fund institutions and initial public offerings of pilot enterprises in order to raise capital and exercise shareholder rights; and
- e. alongside the continued development of the banking infrastructure (bank supervision legal and regulatory reform, bank accounting reform), modest additional assistance to support the implementation of commercial law should be provided.

3. Enable vibrant land and agricultural/food product markets to emerge by:

- a. strengthening the Association for the Protection of Land-owner Rights (APLR) to complete issuing of land titles and then facilitating the formation of efficient markets for the sale and resale of land parcels; and
- b. launching a new three to five year assistance activity, initially with a \$3 to 4 million funding tranche, to establish privately owned and operated farm stores and agribusiness service centers to promote profitable agricultural and agri-processing product/market/value chains for both domestic and foreign markets.

In the report's Section II below, the team presents its findings and recommendations that support the above conclusions. The annexes contain a chart indicating the specific portfolio adjustments that would be required, as well as a list of those whom the team contacted during its three weeks' work in Georgia.

II. Key Elements of USAID/Georgia's Economic Reform Program

There are two fundamental thrusts to USAID/Georgia's strategy to encourage the transition from a centrally planned economy to broad-based economic growth in a relatively free-market economy.

- **The first thrust involves reforming the enabling environment** -- the set of policy, regulatory and administrative reforms of government and private industry needed to create the conditions under which private enterprise can thrive and the fundamental interests of consumers and investors can be protected. This thrust embraces the bulk of USAID/Georgia's economic assistance activities to date.
- **The second thrust consists of working directly with firms, producer groups and individual microentrepreneurs and farmers** to stimulate production, marketing, processing, service provision, or other economic activity that offers employment and earnings opportunities for Georgians (particularly those who are economically disadvantaged). In this latter area, USAID/Georgia's support of micro- and small/medium enterprise promotion -- through various non-governmental organizations (NGOs) and in the new contract with Sibley International and its partners under the Georgia Enterprise Support Program -- are perhaps the best examples.

The Assessment Team believes that the fundamental adjustment to USAID/Georgia's program at this juncture may consist of a combination of measures that, in toto, have the effect of enhancing USAID's direct impact on the enterprise/entrepreneur level. The recommended measures would also strengthen the market and product value chains that permit individuals and groups to benefit more fully from the gradually liberalizing economic climate.

The team's findings and recommendations below address both of these strategic thrusts.

A. Reforming the Enabling Environment

To improve Georgia's enabling environment for private enterprise, USAID has appropriately focused on four key program areas:

- macroeconomic reform (particularly in governmental tax, customs and expenditure-control);
- enterprise privatization (involving the full range of large and small state enterprises);
- land privatization (including both urban and rural land); and
- financial markets and corporate governance (including reforms in banking, applying international accounting standards and enterprise viability).

The team's recommendations on each of these topics follow.

1. Macroeconomic Reform:

a. Macroeconomic Context

Georgia's economy continues to grow. In 1996-1997, economic growth was roughly 11% annually, slowing considerably in 1998-1999 to about 3%; early estimates of 2000 have it so far around 4.5%. There is also monetary stability. There was effectively no inflation from the beginning of 2000 through end-May, maybe even some deflation. And the exchange rate has been stable.

However, while economic growth has been moderate to robust, the distribution of the gains has been exceptionally unequal. Income inequality in Georgia is among the highest in the transition region and among the highest in the world in fact; comparable to that found in some of the most unequal economies of Latin America and Sub-Saharan Africa.

i. Corruption

Corruption has certainly played a role in this highly skewed income distribution. Some are getting very rich in the current (corrupt) system, most are just getting by. Corruption is endemic and widespread. Cross-country comparisons show that corruption in Georgia is among the worst in the Europe/Eurasia transition region and among the worst worldwide. Transparency International's 1999 Corruption Perceptions Index shows that Georgia ranks 84th out of 99 countries worldwide in the degree to which corruption is perceived to exist among public officials and politicians; for the transition region, it ranks 18th out of 24 countries. It's worth noting, however, that while it may be a fundamental problem in Georgia, it is a problem that is not unique to the transition region. In fact, corruption is perceived to be a greater problem in a handful of other countries, including Azerbaijan, Uzbekistan, and Kyrgyzstan; and by these measures, Georgia's corruption is on par with that found in Kazakhstan and Albania.

Corruption flourishes in part because Georgia lacks a government that is able to set the rules and establish a level playing field. Consequently, the economy suffers from inefficiencies (with much economic activity occurring unofficially), overseen by a government without sufficient authority and credibility; a government that is not only unable to establish the rule of law, but is unable to play the critical role of distributing the gains among society. The economy then is caught in a sort of "low-level equilibrium" characterized by "vicious circles."

ii. Fiscal Problems

At the core of Georgia's present macroeconomic predicament are the financial difficulties of the government, which have set the pattern for the economy as a whole. Tax revenues as a percent of GDP (roughly 10%) are among the lowest in all the transition countries. Expenditure arrears, mostly in wages, pensions, and social benefits, have been accumulating for several years and now stand at roughly 5% of GDP. Arrears on external debt principal payments reached 115% of gross reserves at end-March 2000.

Roughly half of the tax revenue that could be raised at existing tax rates is foregone. (The lowest tax compliance is the with taxes collected by Customs, at 30%.) This stems in large part from corruption and tax evasion and a large informal economy. Smuggling, particularly of petroleum products, cigarettes, and ethyl spirits, is widespread, especially where the central government has little authority such as in Abkhazia, Ajara and South Ossetia. Much of the challenge stems from the

existence of a vicious circle with expenditure arrears and tax revenues: the state does not get enough tax

revenue to pay its staff a living wage, and state employees in turn seek bribes to supplement their meager wages. This form of "informal" taxation keeps government revenues low and businesses and individuals in the informal economy. Most estimates of the informal economy in Georgia show it to be among the highest of the transition countries as a percent of the official economy, anywhere from 40% to 60% of GDP.

Expenditure leakages are also a significant problem. Soft budget constraints are widespread. The IMF reports that only 20% of the 600 largest taxpayers pay taxes due in full and on time. There is foregone tax revenue from some state-owned enterprises as well; in general they do not submit dividends or profits to the budget. However, it should also be noted that team visits to a sample of enterprises confirmed that many are not operating and have no revenues to be taxed. While many are not profitable, enterprises which could pay tax revenue include those in infrastructure and energy (ports, railways, airport, local and international telecommunications, natural gas transit and distribution, and oil extraction). Note: all are in debt, and with the exception of gas, telecoms and oil, will never be commercially viable.

iii. Integration into the Global Economy

One key means of improving economic efficiency and productivity is to integrate more fully into the world economy. This is critical for any country, but more so for a very small one. Georgia's economy is among the smallest of the transition countries, perhaps less than 2% of the Russian economy, to put it in some perspective. While Georgia scores relatively high in trade reforms and trade liberalization, it remains relatively autarchic. Its trade sector is among the smallest in the transition countries, comparable to Albania and a handful of others; its merchandise trade has only been about 10% of purchasing power parity GDP. Georgia does not produce much that is competitive in the world markets. Its principal exports in 1999 were metals (24% of total exports), much of this scrap metal. (From January-May 2000, scrap metals were the largest commodity exports, at 12% of total exports). Once a major agricultural exporter, Georgia is now a net importer of basic food commodities. Georgia's wine, tea, fruit, nut and other agricultural products still rank second only to metals, at over 17% of total exports. Partly reflecting this inability to compete have been the large, seemingly unsustainable, current account deficits, which have not been below 6% of GDP since the transition began.

Russia remains Georgia's main trading partner, though the crisis in Russia contributed significantly to at least temporarily reducing Georgian exports to Russia. In 1994, 34% of Georgian exports went to Russia. By 1999, this proportion was reduced by almost one-half, to only 19%. Early estimates of 2000 trade patterns show some rebound in the proportion of exports to Russia, 21%.

In addition, foreign direct investment (FDI) remains insignificant. On a per capita basis, FDI fell from \$44 in 1998 to \$19 in 1999, below the Eurasian average of \$24, and far below CEE standards (where in the Northern Tier CEE it was \$178 in 1999). According to one source, total fixed capital investment in Georgia (i.e., domestic and foreign) fell 57% in 1998 and by 28% from first quarter 1999 to first quarter 2000, largely because of the cessation of pipeline construction.

Georgia's external debt and debt service are among the highest of the transition countries. Total external debt in 1998 was 353% of exports. By this measure, only Armenia and Albania are further

in debt. Total debt service increased from 17% of exports in 1998 to 22% in 1999, one of the highest proportions in the transition region.

v. Economic Reform Progress

It may be helpful to put much of the aforementioned challenges in a wider context. Economic reforms (alongside democratic reforms) have been moving forward in Georgia in recent years. Moreover, while Georgia has far to go, its economic reform progress is in the middle of the pack of the Eurasian countries. By EBRD measures, Georgia ranks 6th out of 12 Eurasian countries and 18th out of all the 27 transition countries in progress in economic reforms, slightly behind Russia and Armenia, and slightly ahead of Ukraine and Albania.

Progress in most of the easier "first stage" economic reforms (in particular, small-scale privatization, trade and foreign exchange reforms, and domestic price liberalization), is farther along in Georgia, and is comparable to some CEE countries (Macedonia most closely). Small-scale privatization is essentially complete: some 12,860 small-scale enterprises were privatized between 1993-1998; 80% of these in the trade and services sector. Georgia is only the second Eurasia country (behind Kyrgyzstan) to attain WTO membership, evidence that it has one of the most liberal and open trading systems within Eurasia.

Progress in Georgia in legal reforms (both extensiveness and effectiveness), in contrast, rates among the lowest of all the transition countries by EBRD scores. Overall, while there has been some progress towards the legal and regulatory framework for a market economy, informal (regional, personal, and clan-based) networks persist. Moreover, until the rule of law is more firmly established [and reform laws are actively implemented and enforced], robust formal sector growth will likely remain elusive and tax collections at an extremely low level relative to the size of the economy.

Progress in "second stage" reforms in Georgia (including large-scale privatization, financial markets reforms, competition policy, and policies towards improving corporate governance) is average for Eurasia. Large-scale privatization is well advanced, closer to Northern Tier CEE norms than Eurasian. Roughly 75% of the medium and large-scale enterprises (950 out of 1,250) have been privatized by end-year 1999 (50 such firms in 1999). The reorganization and privatization of the electricity sector is well advanced in comparison to other countries in Eurasia, and privatizations of telecommunications are expected to proceed in late 2000. Highlights include the privatization of the Tbilisi area electricity distribution enterprise (in January 1999), the Gardabani thermal generation plant in Tbilisi (January 2000), and several other small electricity distribution enterprises.

b. Fiscal Reforms: Tax, Customs and Public Expenditure

Addressing the government's fiscal problems needs to be the highest priority for donors. The expenditure arrears and government's soft budget constraints set the pattern for the entire economy. The challenge is to do the reforms in a way that meets short-term (fiscal) needs while laying the foundation for longer-term (development) imperatives. This means that tax reforms need to be done in a way that increases government revenues with an eye towards also encouraging investment and private sector economic activity. In addition, managing expenditures needs to be done in a way that minimizes social costs; i.e., how and where expenditures are cut is key. Clearly these matters must

be addressed in unison with the IMF's and the World Bank's ongoing efforts.

The current task order for USAID/Georgia's (Phase II) Fiscal Reform Program with Barents extends through September 2001, and will cost about \$6.9 million, which includes \$1.5 million of computers for the tax administration. The U.S. Treasury Department is also providing some assistance in fiscal reform. The main components of the task order are tax administration (including computerization and training),

tax policy (writing regulations for the main taxes), macroeconomic assistance to the Ministry of Finance (revenue forecasting) and budgetary assistance to the Parliament.

i. Tax and Customs Administration

It is widely recognized that most of the focus towards decreasing the fiscal deficit needs to be on improving tax administration and enforcement. Roughly one-half of the tax revenue that could be raised at existing tax rates is foregone. Moreover, tax revenues have been relatively inelastic to changes in tax rates. Primarily as a consequence of the dismal record of collecting tax revenues, government expenditure arrears have mounted, and now stand at roughly 5% of GDP. The social costs of these arrears have been high; the relatively disadvantaged segments of the population have been hit hardest by the spending cuts and non-payments.

(a) Tax Department Reorganization

The main focus of USAID's fiscal reform program is the reorganization of the tax department. This focus is well-placed. The implementation of this reform was delayed because of delays in signing the Memorandum of Understanding (between the governments of Georgia and U.S.). It was also held back by changes in the government of Georgia (the Ministry of Revenue was created and its minister empowered, eventually, with the authority to follow-through on the reorganization). However, the implementation plan is moving forward and appears to be reasonably on target. The MOU was signed in March 2000. The groundwork has been laid in several aspects. This includes the development of a training curriculum to assist new staff with their functionally organized duties. The Tax Administration Computer System (TACS) is installed in three pilot offices. A public education campaign to increase public awareness and support for the reforms has been developed.

As part of the staff reduction process, the first round of testing of tax department employees begins in August 2000. Barents estimates (and others agree) that the re-organization of the tax departments in Tbilisi can be completed by end-December 2000, and that the reorganization of the tax departments in the rest of the country can be completed, as originally planned, by September 2001. In any event, the process has essentially just begun.

Overall, the plan is well-conceived and appropriately ambitious. The process incorporates appropriate incentives or conditions ("accreditation phases") to encourage results along the way. The political will to make the difficult changes appears to exist. Both the Minister of Revenue and the Minister of Finance are supportive and appear to have a firm grasp of the urgency and of the appropriate priorities.

While we have no suggestions to change the current plan, it should be noted that there will be a need for some follow-on activities to sustain and further the reforms. The computerization at the end of the current activity, for example, will not be complete. Additional functions will need to be

installed, such as additional modules to cover all the taxes (the current computer modules will cover only the four main taxes). Further computerization will be needed for audit selection, and additional collection functions will likely be needed, such as prioritizing collections based on such factors as age of arrears. This computerization, however, would require a follow-on activity beginning in FY 2002.

Recommendation:

- **Stay the course. We should know by December 2000 if the Tax Department re-organization has had a substantial impact. We will also know by then if the government has been successful in meeting the conditions for a resumption of a formal program with the IMF.**

(b) Customs Administration

It is doubtful that the government of Georgia can significantly raise tax collections without addressing the issue of low collections by Customs. Roughly half of total tax revenue should be coming from Customs. Yet tax compliance, at 30%, is abysmally low from Customs. Moreover, Customs collections appear to be getting worse, in contrast to tax collection trends in the Tax Department (which has made some improvement in tax collections over the past year). Large amounts of gasoline and diesel are being smuggled into Georgia and there seems to be a lack of will on the part of Customs to tackle this issue. In fact, in recent months, these collections have dropped precipitously. Tax avoidance by these taxpayers creates serious problems for legitimate businesses that have difficulty competing with the lower prices of smuggled goods.

Customs needs an overhaul similar to what is being tried in the Tax Department, including an infusion of “new blood” in the ranks and new management. Despite the consequences of inaction, no major donor has yet been willing to step forward to take the initiative to reform Customs. U.S. Customs does currently have a program with Customs (focused primarily on border guards). However, the consensus is that it is neither well equipped nor free to perform its duties to the full extent of the law. USAID may wish to consider complementing or supplementing assistance from the U.S. Customs Service in order to enhance overall impact of the U.S. assistance effort in this vital area.

It is widely recognized that reforming and restructuring Customs will be more difficult than doing the same in the Tax Department. Corruption is greater in Customs. There is more money involved and more powerful vested interests in various smuggling clans. Most argue that the current Customs leadership is not receptive to change. Some argue, hence, that now is not the right time to affect change. Moreover, the challenge of reforming Customs may be linked to a wider issue, of territorial conflicts and sovereignty, and hence is very politically charged.

Intertek Testing Services (ITS), a U.K consulting firm, has invested \$1 million in anti-smuggling efforts, largely through the implementation of a pre-shipment inspection (PSI) program. It has met with some success, and has proposed a restructuring of Customs similar to that of the Tax Department. The Assessment Team's discussions with Neville Bissett of ITS revealed a more optimistic perspective than most on the possibilities for effective change in Customs. He estimated, as underscored in the July 2000 ITS business plan, that it would take roughly \$3.5 million to implement the necessary institutional reforms of Customs.

At the request of the government of Georgia, both the World Bank and the IMF are once again independently conducting assessments of Customs to determine the scope of the problem and presumably a game plan for action. These assessments should be forthcoming before year's end. Neither these assessments, nor the various concerned donors, however, are well coordinated on this problem at this point.

Recommendations:

- **At the least, USAID/Georgia should take some initiative to increase the visibility of this issue.**

One option would be to form a high-level, highly visible committee that would include the major donors and senior parliamentary and GOG officials.

- **Consider using the tax department re-organization as a model for action, depending on results in the coming months of that plan. The forthcoming assessments from the World Bank and IMF should also guide action.**

ii. Tax Policy

Tax policy, alongside how it is administered, is a significant obstacle to business development. First, the overall tax burden is high. There are too many taxes, especially "nuisance" taxes such as the road fund. Social taxes are burdensome and are not used ineffectively. Presumptive taxation should be instituted to simplify and add transparency to the collection process.

Second, the tax code is continually being amended. It has undergone sixteen major amendments, in fact, since it was adopted in 1997. Third, there are too many kinds of taxes; the tax system is much too complicated. So complicated and fluid is the tax regime that businesses, particularly SMEs, and farmers are generally unable to comply even if they have the financial means and the will. Moreover, there is little means by which enterprises and taxpayers can get access to the tax information that they need.

These factors, combined with the frequent harassment from the highly corrupt tax agencies, result in frequent and burdensome fines for noncompliance for the small businesses and farmers. The interest rate for late payment of taxes is high, an annual rate of over 70%. In fact, the interest and penalties can end up being more than the tax, and can put a taxpayer out of business, as evidenced by enterprises the team visited.

What is needed then are fewer changes to the tax code. The tax reform implementation plan for the Tax Department proposes a system whereby amendments to tax law are allowed once a year, as part of the budget formulation process. This makes sense. As part of this, there may be a need for some oversight in Parliament to prevent tax code amendments from being introduced.

In addition, taxes need to be simplified. Changes that would simplify the system that are, by and large, revenue neutral should be considered. Tax simplification helps at both "ends;" for the small business and/or farmer who lacks the capacity to comply to a more complicated system, as well as the tax department which does not have the capacity to audit and collect taxes from more sophisticated systems (like the profit tax, etc.).

Consideration should be given to a presumptive tax on all small businesses to replace most if not all other taxes. Similarly, tax simplification for farmers should be considered. By one count, there are up to ten different taxes imposed on agriculture in Georgia, including an entrepreneur tax, a traffic fund, a dividend tax, unemployment fund, and so on. The simplest system, and hence perhaps the best, would be a flat land tax that would take the place of most if not all taxes on farmers. In addition, consideration should be given to take this one step further; namely phase in this tax over several years, perhaps three to five years. Except for the land tax, tax revenues from farmers are negligible (most farmers are simply unable to pay and/or pay an "informal" tax in a bribe instead), and so revenue losses to government will be minimal. A tax holiday for farmers could also give an added incentive to produce, which in turn should generate additional tax revenue in the future.

A land tax is superior to other taxes in the sense that it does not distort decisions about investment and labor input. Moreover, the land tax is much more transparent and relatively easy to calculate and to control (corruption can be minimized).

There are of course costs alongside benefits to consider in any plan, and these would need to be thoroughly analyzed and vetted. One concern, for example, towards giving preferential treatment in a tax holiday to farmers is the possible effects and reactions from other sectors of the economy. Moreover, while simplifying taxes for farmers as such should stimulate economic activity, there may be other elements more important in regard to improving productivity and output than taxes, including poor transport conditions, customs corruption, absence of marketing, poor quality of products, and others.

The VAT (Value Added Tax) may also need to be re-examined. The introduction of the VAT for larger farms has not been a success and has generated little revenue.

There is a relatively high VAT-threshold, currently set at an enterprise turnover of 24,000 Lari, and this excludes the large majority of farmers. However, the threshold is a disincentive to merge land plots or farms, and hence may stimulate farming at a sub-optimal scale in some cases. In addition, the effective exemption of the smaller farms from VAT means that they are not eligible to reclaim taxes on inputs, and that they may in fact suffer from a higher VAT burden than the bigger farmers.

Hence, Georgia could consider lowering the VAT rate on certain inputs, which can only be used by farms, to zero percent, namely on irrigation equipment, fertilizers, pesticides and seeds. Again, the impact on government revenue would be minimal, but the lower priced inputs would provide some stimulus to greater productivity and production.

Recommendations:

- **Focus more attention on the impact of tax policy on the economic activity of SMEs and farmers, and seek ways to simplify the tax system to better stimulate economic activity.**
- **Endorse the importance of minimizing the number and frequency of changes in the tax code, and consider oversight in parliament to this effect.**
- **Engage in a dialogue with the IMF in Washington on how best to stimulate agriculture through tax policy. This would include consideration towards a tax holiday for farmers and a phased-in flat tax as the primary if not sole tax on agriculture. Consider the merits of the VAT tax on agriculture as well in this discussion.**
- **In concert with the IMF, bring an expert (or a team) out to assess tax policy towards agriculture.**
- **Consider working towards lowering tax penalties [Art 218(7), Art 254, and Art 273 (24) may be the most egregious (see July 10, 2000 memo from S. Hester)], and having the laws on tax penalties distinguish between (inadvertently) negligent behavior and willful behavior. Consider whether the interest rate for late payment of taxes can be reduced to a more reasonable level or capped, while at the same time discouraging abuse of the lower rate.**
- **Work with banking reform to consider changes in the law to prevent the tax department from freezing bank accounts without adequate due process.**

- **Work towards improving access to tax information for small businesses and farmers.**

iii. Public Expenditure and the National Budget

Advisors, including the US Treasury, are working with the Ministry of Finance and Parliament to improve budget laws, forecasting ability, and the formulation and execution of budgets. This work is extremely important, not only to improve the budget process, but to improve the tax system. Inflated revenue estimations are used to create revenue targets and quotas for the tax administrators. These targets result in pressure on taxpayers to make advance payments of tax.

Two areas in particular that may need greater focus on the part of the donor community are estimating tax revenues and tracking expenditures. Reasons as to why there currently exists a low capacity in the GOG for estimating tax revenues include a lack of reliable data necessary for accurate forecasting and a lack of technical capacity for forecasting. Fragmentation of responsibility among the Ministry of Finance, Ministry of Revenue, and Ministry of Economy, Industry and Trade has also been a contributing factor. There is a need to centralize revenue forecasting responsibilities with the Ministry of Finance and for better coordination and effort on the part of US Treasury, USAID, the IMF and the World Bank.

There is also a great deal of "leakage" in the process of transferring revenue to the spending agencies and along down the line to the end recipients. Moreover, the Ministry of Finance has a low capacity for accurately tracking expenditures.

Recommendation:

- **Work to ensure that more donor attention and resources are devoted to key budget and expenditure issues. This should include helping to centralize revenue forecasting responsibilities with the Ministry of Finance and increasing its capacity to forecast revenues and track expenditures. The Government of Georgia must improve its treasury and public accounting systems to achieve adequate expenditure control.**

2. Enterprise Privatization

The Georgian privatization program has only realized limited success over the last two years. Major strategic industries have yet to be privatized with the exception of the distribution component of energy. Others such as Poti Port, the telephone company, textile, steel, fertilizer, etc. are still state owned and most are inoperative and with heavy liabilities to the state. The steel plant, for example, has a debt of US\$60 million. In addition, the state still owns residual shares in up to 300 enterprises that have been partially privatized. These range from 10 % to over 50 % state ownership.

The Barents Group has provided consulting service to the Ministry of Privatization (Ministry of State Property) over the last two years. A cash auction system that would have quickly cleared the pool of residual state owned minority shares was never developed. Instead, Barents was directed to focus on nine strategic enterprises utilizing a complex, politically controlled, carve-up approach to privatization. The approach seeks to split each large industry into separate operating units and privatize as a stand-alone

unit with a foreign investor or outside domestic investors. This approach has not worked in the NIS countries and the Barents team stated that there was limited opportunity, if any, of this approach working in Georgia.

Moreover, the overall privatization program has failed to resolve two policy issues that have traditionally limited enterprise privatization in Georgia.

- First, most enterprises have debt to the state that investors are unwilling to absorb when purchasing a state owned enterprise through the privatization program.
- Second, the Government continues to offer enterprises for sale based on the old soviet book value which is many times over the market value. Only after five tender offers, will the Government consider a price under the book value. This complex approach is precluding the privatization of enterprises.

Recommendations:

- **That the Barents privatization assistance be terminated at the completion of the current Task Order in September.**
- **That future privatization assistance take the form of cash auction through the capital markets. However, assistance to implement a cash auction would only be provided after resolution of the above two policy issues.**

3. Land Privatization

a. Land Ownership/Property Owners' Rights

By the end date of the current task order on September 15, 2000, the USAID Land Privatization Project expects to have assisted in the registration of approximately 1,000,000 non-residential agricultural land parcels. Registration is near completion in 20 of the 38 raions being supported by the USAID Land Project. The Project has also assisted in the privatization of enterprise land for approximately 6,500 out of an estimated 10,000 privatized and newly-formed private enterprises throughout Georgia that have land. Of the remaining enterprises, many are not operating or viable

and therefore do not have the resources or incentive to privatize their land.

The Land Project's organizational framework and system for surveying and registering the private land is effective and should be continued at least through year-end 2001. By that time, the project anticipates completion of the surveying and registration of 3,000,000 non-residential, agricultural parcels that were distributed in the first round of privatization. Achieving these targets will require either an extension of the current task order or establishing a new task order. In either case, responsibility for managing the Land Project could be shifted to a Georgian NGO with a gradual phase-out of expatriate consultants, as long as there is a clearly defined transition/ development strategy for the local NGO (see recommendations below).

The current composition of the Land Project, as managed by Booz, Allen and Hamilton, includes a

central organization comprised of the following teams:

- Legal regulatory team (4 people) that advise and lobby the Parliament and Chancellery on legislative and policy issues;
- Transaction team (3 people) that trains and coordinates real estate subcontractors who facilitate enterprise land privatization/registration and secondary transactions of agricultural land; and
- Agricultural Land Registration Team (15 people) that trains and coordinates the surveying contractors who prepare all cadastre and map documentation necessary for the registration of privatized land.

The project has been effective in setting up private companies that provide contractual services to carry out surveying, registration and secondary transaction activities. To date, 35 surveying companies with approximately 1,200 contractors and 5 real estate brokerage companies with approximately 75 contractors have been formed. Many of these companies will become commercially viable as the land market develops.

Other functions of the Land Project have already been transferred to the Association for the Protection of Land-owner Rights (APLR), though funding for the associated salaries and activities continue to be provided through the Land Project. Specifically, the manager of public education and media relations activities is now part of the Association staff, as is the lawyer who manages the regional outreach efforts.

The Land Project funds and the Association oversees the activities of regional offices in Kutaisi and Telavi, and ten other individuals who cover separate regions throughout Georgia. These outreach teams resolve potential conflicts and provide information to landowners. The Association also runs a telephone information line. Since June, the central and regional offices have received 1,000 calls from individuals seeking information on their rights, advice/mediation in resolving a conflict or assistance in registering their land.

Recommendations:

- **Land project: Continue to support the Land Project efforts in the registration of agricultural land to a total of 3,000,000 parcels. Shift responsibility for the Land Project into the Association for Protection of Land-owner Rights (APLR). The current configuration and management structure of the Land Project should be maintained with the following possible adjustments:**

- (1) **The transaction team could eventually be downsized from 3 to 2 people.**
- (2) **Encourage the development of more raion-level real estate broker/facilitators through training by the Land Project's transaction team manager.**
- (3) **Develop a 6-9 month transition plan that will allow for the gradual ramping down of payments to real estate brokers for enterprise land privatization transactions, while allowing them to begin charging for their services. Transition from donor support to fee for services on agricultural land transactions should be more gradual—over 1½ - 2 years, depending on whether the project is extended to support registration of the current state**

leased and unallocated land.

- (4) The Legal/Regulatory team should continue to work with the Parliament and Chancellery to develop appropriate legislation.**
 - (5) The APLR continue and possibly expand its outreach efforts through the Association's hotline and regional legal/public information outreach teams.**
 - (6) Maintain the current size and configuration of the surveying team and encourage the cost-sharing purchase of surveying total stations for the surveying companies (30-40 @ 1/2 of \$8000 each).**
- **Association for the Protection of Land-owner Rights: Either Booz, Allen Hamilton or a newly-contracted, western NGO could provide financial oversight and advise APLR during a transitional period of approximately 18 months. From the outset, there should be a transition strategy with a clearly defined schedule for APLR to assume responsibility for financial management of the project. During this transitional phase, APLR will also develop a long-term strategy for institutional development and commercial viability. This strategy should emphasize integration of other groups such as real estate brokers and surveyors into a unified association.**

b. Distribution of State Unallocated and Leased Land

There is growing consensus among government and parliamentary representatives that the state-held leased and unallocated arable land should now be privatized. Privatization advocates disagree, however, on the methods for distributing the land. Distribution plans vary depending on whether more weight is given to social equity or commercial viability concerns.¹ Elements of the distribution plans include:

- **Recipients**—The spectrum goes from a mass distribution of small parcels of land to a selective distribution that gives priority to current leaseholders; zero auctions for non-lease holders are considered a means to distribute unallocated land in the latter case.
- **Price and system of distribution**— Most land privatization advocates suggest using some multiple of the land tax in direct sales to leaseholders for their leaseholds. [Land tax X 10 is currently being promoted by the State Department of Land Management (SDLM) and APLR]. Land remaining after the time limit would be added to unleased arable state land to form the pool for an auction. The auction would be open to the remaining rural residents, with suggested limitations according to residency (i.e., by village, raion, etc.). Distribution free-of-charge is not considered politically feasible, as the GOG is seeking some revenue from this privatization.
- **Timing of distribution and of payment**—SDLM supports the honoring of leases, even if those leases are for 10 or more years; APLR and the head of the Economic Reform Committee are willing to break the leases, as long as leaseholders are given priority to purchase their leaseholds. They suggest a time limit for these priority purchases.

There are approximately 958,000 ha. of leased land and 183,000 ha. of unallocated (non-leased) arable

¹ For a good discussion of the advantages and disadvantages of various alternatives for privatizing state-held arable land, see the memo dated May 26, 2000 by Bob Cemovich, chief of party for the Land Project.

land, according to government figures. The remaining unallocated land is pastureland.

Representatives of the SDLM are suggesting that this unallocated pastureland be left in state control. In this way, many rural households that depend on the state-held pastureland for grazing their livestock retain access. If the unallocated pastureland remains in state control, the pool of land available for this second round of privatization amounts to 1,140,500 ha. of which approximately 84% is leased.

According to Overseas Strategic Consulting's (OSC) recent survey, the majority of leased land is held by farmers who lease less than 200 ha each. Moreover, the survey found little evidence of subleasing. This dispels the common assumption that many leaseholders are land speculators who control vast estates. However, only 15% of the rural population are leaseholders. There are obvious social equity issues associated with strategies that will give 15% of the population priority access to 84% of the land to be privatized in this round.

The goal of this privatization is to move arable land out of the public sector. While the first round of privatization was intended to ensure each rural household received a parcel of land, most agree that this round is intended to create viable, commercial-scaled farms. The simplest way to do this is to give priority purchase rights to the current leaseholders. However, this strategy will effectively exclude 85% of all rural residents from access to 84% of the land to be privatized in this second round. Many Parliamentarians support a strategy that gives priority to leaseholders. Many Parliamentarians are also themselves leaseholders.

Since leaseholders are often perceived as those who used connections or political clout to gain control of the best state-held land, a strategy that gives leaseholders priority access to the majority of land in this phase of privatization may be unpopular with a large percent of rural residents. However, many leaseholders have also made investments in their leased land and are likely to be quite vocal in their opposition to any strategy that would deprive them of what they perceive as their land.

Use of the land tax as a determinant of the base purchase price may also raise objections. Some claim that land tax does not accurately reflect the variability of land quality (i.e. irrigated land vs.

land with non-functioning or no irrigation). The Germans and many in the SDLM take this even further and want to conduct a soil survey to determine the quality of the land. If the distribution were dependent on this soil survey, it would slow the process and raise the cost significantly.

The OCS survey shows 47% of the rural population disagree with the government's current direction on agricultural reform. Although it is likely that this dissatisfaction is based on erroneous assumptions or lack of information, it should not be dismissed. Whatever distribution strategy is adopted for privatization of this land, efforts should be made to expand public understanding and build public support for this program.

Recommendations:

- **Provide assistance to the Parliamentarians (Heads of the Agricultural and Economic Reform Committees) and the Ministry of Agriculture in their efforts to adopt a clear policy for the privatization and registration for the remaining arable land in state control.**
- **The policy/approach supported by USAID should include elements that are quick, transparent and promote the formation of commercially viable farms. Therefore, priority**

should be given for a limited time to current leaseholders to purchase their

leaseholds for some multiple of the land tax. Use of normative prices should be discouraged. Instead, whenever possible, price information on land sales and leases could be used as an indicator of the market value of land. After the set time for leaseholder purchases has expired, a Dutch or zero auction could be held to distribute the remaining leased land and any land that has not been held under lease (unallocated land).

- **While this approach to distributing unallocated and leased state land emphasizes commercial viability, integration of elements that would increase social equity should also be considered. For example:**
 - **a shorter timeframe for priority purchase by existing leaseholders (6 – 12 months) and higher initial purchase prices may increase the pool of land available for auction to the rest of the rural population.**
 - **There have been rumors of selective purchase financial assistance to leaseholders for purchase of land. This should be discouraged.**
 - **Prior to the vote on the law that will determine the strategy for privatization, Parliamentarians could be asked to disclose the amount of land they and their immediate family control.**
- **APLR should hold more meetings throughout the country to inform rural residents of the draft legislation and solicit feedback from them on this issue. The Association should hold some meetings at village level. Every effort should be made to more actively engage participants in a discussion of the process as outlined in the draft legislation. Other outreach vehicles should also be employed. The goal is to promote better understanding of the process by rural residents, solicit feedback, and build public support for the policy.**
- **Assist GOG to develop and implement the privatization of state leased and unallocated land through APLR or another independent contractor. Depending on the strategy adopted, this could entail running auctions or conducting other elements of the distribution. Assistance with registration of these parcels could also be considered, but may conflict with the German intentions to survey all leased and unallocated land currently held by the state.**

c. Consolidation of Agricultural Land

During the first round of agricultural land distribution in 1992-99, rural households received ownership of various types of land—their residential/household garden plots, arable land and vineyards—totaling a maximum of 1.25 hectares for each household. This distribution process provided that each rural household would have access to various types of land, but also led to a fragmentation of agricultural land. This fragmentation often precludes the use of equipment as owners of adjacent small plots often plant different crops. Moreover, arable land and vineyards are often not conveniently located. The OSC survey showed that 35% of farmer/peasants have plots that are 4-10 kilometers from their homes, and more than 10% have plots over 10 kilometers away. Since most rural residents don't have ready access to transportation, tending these crops can be difficult.

Consolidation of agricultural land will allow the formation of viable farms that are scaled for use of agricultural equipment. Consolidation of parcels will also address the impracticality of a farmer trying to cultivate several small parcels that are convenient neither to his home nor to each other.

The German organization KfW intends to conduct a pilot project under the DM 30 million loan approved by Parliament earlier this year. They intend to encourage consolidation through unspecified, non-market approaches. According to the KfW representative, such consolidation would be based upon soil quality evaluation. This process would be time-consuming and costly if rolled out across Georgia, and could significantly delay the development of land markets. USAID supports consolidation of agricultural parcels through land market development. That said, land markets in Georgia remain significantly constrained at present. There have been some secondary transactions, including 1,153 registered parcel sales and 25 registered leases. But according to the Land Project transaction team, approximately 40% of these secondary sales are to people from Tbilisi. Few rural residents have the liquidity to purchase land outright.

Moreover, credit is not available to finance land transactions since interest rates are too high, and most banks will not currently lend to the agricultural sector. In order to discourage speculation and encourage retention of land assets by rural residents, the Land Project has shifted its emphasis from promoting sales to promoting land leasing. This approach enables some initial consolidation in the face of a tight credit market.

Ultimately, vibrant agricultural land markets are contingent on a vibrant agricultural sector. Producers will not seek to expand their land holdings unless they have access to markets for their produce and are able to pay their taxes. The tax reform and market-linkages programs recommended elsewhere in this report will contribute significantly toward stimulating agricultural sector development. However, there are some activities that could be undertaken to promote land market

development in the interim.

Recommendations:

- **Develop credit mechanisms by:**
 - **Strengthening linkage between the Land Project real estate consultants and existing USAID credit programs;**
 - **Providing training to both real estate consultants and credit union/association loan officers on purchase price mortgage lending;**
 - **Exploring uses of the Loan Portfolio Guarantee through the Global Bureau's Credit and Investment office to support land market development programs;**
- **Continue to promote an environment more enabling of land market development. Specifically, lower registration fees (currently GEL 26 per parcel) and notary charges (currently 1-3 % of the transaction) on all subsequent transactions. Consider privatization of registration offices; or promote adoption of a policy that would allow registration offices to retain some or all of their collected fees.**

- **Expand support for and tracking of secondary transactions, including rental and sale price information; consider developing a mechanism for distributing land market information and advertising land for sale or lease.**

4. Financial Markets and Corporate Governance

The capital markets and accounting programs began in January 1997. The infrastructure for these two industries and oversight bodies are in place and all are operating in a start-up phase.

a. Capital Markets:

The capital markets component includes: The National Securities Commission of Georgia (NSCG); The Georgian Stock Exchange (GSE); a depositary; eight independent share registrars licensed by the Commission and thirty-four licensed brokerage companies. The mass privatization program created 363 private enterprises with 100 shareholders or more which could be listed on the GSE. To date, 99 are listed and can begin trading.

One innovative approach to the Georgian capital markets is found in the NSCG. Two foreigners were selected as NSCG commissioners (an American and an Australian). The five-member commission elected the American as Chairman. In less than three months, this composition has already begun to force discipline and transparency for industry participants.

The one missing element of the capital market infrastructure is the absence of investment funds that were created in the other NIS countries through the mass privatization program. These funds were never allowed to emerge as a major participant in the Georgian mass privatization program due to

government fear of corruption and a lack of vision as to their future role in a market economy. In the other NIS countries, these funds have evolved into investment/venture capital funds. They are now playing an important role in replacing old “red managers” with young entrepreneurs who are beginning the process of enterprise restructuring. The absence of these funds in Georgia will make the enterprise restructuring process more difficult, but the process must continue in their absence.

b. Accounting

The accounting infrastructure now has the foundation for shifting from the Soviet accounting to conversion to International Accounting Standards (IAS). This includes:

- the legal and regulatory framework (although the Government still needs a law to move certification of auditors out of a state agency and into an industry association);
- an audit and accounting association that has a charter and accompanying legal authority to function as a self-regulatory organization (SRO);
- curriculum reform including the capacity to offer training in the Association of Certified Charter Accountants (ACCA) program; and

- two oversight bodies that will have some authority over the accounting profession. They are the Chamber of Control, housed in the Parliament and the National Securities Commission of Georgia.

The Georgian Federation of Accountants and Auditors (GFAA) is one of the only two SRO's in the NIS to be accepted as full member to the International Federation of Accountants and Auditors (IFAC). The GFPAA and its members will be primarily responsible for the conversion of both financial and managerial accounting in industries and businesses throughout Georgia. In addition, the GFPAA's English language ACCA program has been underway since 1999 and currently has 125 students at various levels of completion. Upon graduation, these students will become new entrepreneurs and managers in business and industry.

The objective of the next phase of market reform activities is to move the present infrastructure of oversight bodies and industry participant to an implementation outreach phase. In the outreach phase, oversight bodies would be fully capable of enforcing transparency and corporate governance. Self-regulatory organizations would become financially viable and demonstrate the capacity to regulate their members thus limiting the government's oversight role. Finally, industry participants would move from a start-up phase to commercially viable enterprises through TA-supported enterprise restructuring activities.

Recommendations:

- **That the current discreet capital markets and accounting projects be combined into a single activity over the next two years with a primary focus on sustainability and the creation of good commercial business practices founded on sound corporate governance. Specific illustrative recommendations are to:**
 - **Move the capital market and accounting SROs to commercial viability.**
 - **Complete the first round of ACCA training.**
 - **Build the capacity of the private audit and accounting enterprises with the skills to restructure enterprises for a fee.**
 - **Build the capacity of investment funds and dealer brokers to assist in restructuring enterprises through better management and the raising of capital through IPOs.**

5. Banking Reform

a. Banking Environment

In common with many other countries of the former Soviet Union, the Georgian banking sector plays a limited role in savings mobilization and in lending to efficient private sector businesses. The reasons are familiar - - high real interest rates, insider and related party lending, difficulty valuing collateral, among other things. And fundamental, is the poor economic performance. Vigorous economic growth (so

crucial for rapid banking sector expansion in countries such as Poland), although not a panacea, is a necessary condition for increasing the role of the banking sector in financial intermediation.

Given the outlook for the economy and government policies described in other parts of this paper, it is likely that discernable improvement will become evident only over an extended period. For the foreseeable future, banking opportunities are sharply circumscribed, given the economic and political context in Georgia. USAID's technical assistance program is calibrated to this reality.

In the current environment bank lending to the private sector cannot be jump-started by, for example, credit lines to banks (and, in fact caution is advised, least these well-intentioned efforts set up incentives for banks to ignore prudential concerns). What USAID is emphasizing is the need to develop the basic building blocks of the banking infrastructure -- to lay the foundation.

Starting as Georgia is from virtually the beginning, this is an extended effort. But these efforts will pay off in time because a well-regulated banking system, with good information and systems in place to assess the financial conditions of banks, not only builds public confidence in the banks as a depository for savings, but gives bank management the ability to allocate investment by market criteria.

b. USAID Banking Assistance Program

The specific elements of the USAID technical assistance program are:

Bank Supervision: There are basically three guarantors of the safety and soundness of the banking system -- the market, the management and owners of the bank, and the government's regulatory authority. In a nascent banking sector market forces are weak, and management too often unable or unwilling to exercise prudent authority. Thus the task falls overwhelmingly on the shoulders of an

ill-prepared central bank supervisory authority. Since October 1999 USAID, in collaboration with the IMF, has provided technical assistance to the National Bank of Georgia (NBG) Bank Supervision Department. Although some of the rudiments are in place, the NBG Supervision Department is still very much in the first stages of its development.

Regulatory Infrastructure: An important bottleneck currently for the efficacy of NBG Bank Supervision is an inadequate NBG regulatory structure. In July 1999 USAID fielded a regulatory lawyer who will develop a new set of regulations, consistent with international standards. These will give NBG Bank Supervision enforcement powers needed to act aggressively against recalcitrant banks.

Accounting Reform, Bank Risk Management and Internal Controls: The second critical bottleneck to better bank supervision and more rigorous bank risk management is poor information because Georgian banks are not converted to international accounting standards (IAS). The way accounting is done in the commercial banks not only gives the NBG flawed information, but also gives bank managers and owners a distorted picture of their bank's financial health. Georgia is decidedly behind many other countries of the former Soviet Union, most of who converted to IAS during the late 1990s. IAS conversion is scheduled for January 2001. In June 2000 USAID brought an experienced central and commercial bank accountant to work with the NBG in guiding this difficult IAS transition. Two more accountants will join the team to work with banks early next year when EU Tacis assistance ends.

Electronic Funds Payments System: Another critical element of the banking system is the execution of the electronic funds payment system. Processing payments in a timely, efficient manner is as important to the development of a dynamic, private banking environment as is its funding. Before the end of 2000, a three-year USAID funded effort should result in a new, highly efficient, real time gross settlement system, greatly increasing the efficiency of the payments mechanism.

Bankers Training: In Georgia bankers still do not have well developed professional skills nor, given the environment, are they being schooled in prudential concerns. USAID has supported a bank training facility for over two years, whose objective was to become a self-sustaining entity after USAID assistance was withdrawn in December 2000. Suffice it to say from hindsight there were problems in both the design and the delivery of this assistance. The current plan is to merge the bankers training effort into a broader financial services training facility, along with other capital market entities, housed within a broader, already self-sustaining institution, such as a university. This approach will minimize fixed overhead costs.

c. Looking Ahead

The ultimate objective is a banking sector which performs well the basic functions necessary for economic growth -- mobilizing savings, funding efficient private sector businesses, transmitting government monetary policy, and efficiently executing the payments system. Given the current economic trajectory touched on earlier, it is unlikely that by the end of the present Bank Supervision Task Order in early 2002, the situation will be dramatically different.

What could, however, realistically be expected during this time is a decided improvement in the prudential regulatory environment, which should by then be largely consistent with international standards and empower NBG supervisors to carry out their prudential responsibilities. Moreover, there should also, gradually be an improvement in reporting by the banks as the IAS methodology becomes more entrenched.

Improvements in the legal and accounting areas will greatly enhance the NBG's ability to perform a better financial assessment of the banks. Starting in 2001 there should be consolidation of the banking system and further reduction in the number of banks since banks' ability to hide losses through creative accounting and/or hide behind poorly written laws and regulations will be sharply circumscribed.

Bank managers too should have a better grasp on the financial condition of their entity although a more extended period will be needed for the revamped accounting methodology to be applied in banks to upgrade risk management and internal controls and procedures. Finally, over the next year a solid beginning should be evident in developing a sustainable, professional training center that services different facets of the financial community, including banking.

In addition, there are important ancillary impediments to efficient bank lending. In particular, the commercial law framework, particularly with respect to securing obligations, realizing collateral, and the rights of secured creditors contains gaps, vague provisions and conflicts. The resulting substantive and procedural difficulties, combined with weak institutions (e.g., judiciary, bankruptcy administrators, execution services), renders lending transactions, including exercising legal rights - lengthy, expensive and uncertain. Increased judicial competency remains an acute need, including to assist the implementation of reforms in banking, capital markets and land privatization and to better ensure parties

to agreements that their rights will be protected in accordance with law. The absence of a collateral registry system for recording liens on non-real estate property, that is a basic element of successful bank intermediation and is contemplated by the Civil Code, causes particular uncertainty as creditors cannot determine that collateral is clear of other liens and must use inefficient practices to address this information gap.

Recommendations:

- **USAID/Georgia should continue to support the banking reform program.**
- **The focus should continue on integrating bank accounting training with other parts of the overall USAID accounting program implemented through the Georgian Accounting Association (recognizing the specialized training that bankers will additionally need).**
- **In addition to the bank specific work in developing western-based accounting methodology in the banks, auditing and accounting firms that are members of Accounting Association should also receive training to develop their specialized skills in the banking area.**
- **Finally, USAID/Georgia should provide modest additional support for the implementation of commercial laws. This would include legal assistance and providing practical guidance to reduce impediments to lending and secured transactions, judicial training on select topics (including preparation of commentaries and handbooks on select priority topics and, subject to fund availability, technical assistance to support the creation of a collateral registry.**

6. Restructuring the Ministry of Agriculture:

With over 4,000 employees, the Georgian Ministry of Agriculture is currently structured, organized and staffed to carry out soviet style command and control activities throughout the agricultural sector. Severe budget constraints over the past several years have resulted in some downsizing in the Ministry and many previous functions and activities are no longer being carried out. However, an inappropriate structure remains, overstaffing continues and clear lines of responsibility, transparent practices and fund accountability are lacking. The Ministry cannot and should not operate as it did in the past, but it is not organized or staffed to perform the functions needed in the future.

The new Minister of Agriculture has recognized the necessity of restructuring the Ministry to meet the needs of a market-driven agricultural sector and has requested foreign assistance in doing so. This implies down-sizing the Ministry in terms of both personnel and assumed responsibilities as well as restructuring to enable the Ministry to implement policy-making, regulatory, monitoring and other appropriate responsibilities effectively.

Assistance to the Ministry of Agriculture's restructuring would directly support one of the four key points in the U.S.-Georgian Four Point Program: civil service/public administration reform. While it is entirely appropriate, and possible, for USAID to focus accelerated reform assistance to this ministry, the initial planning will have to ensure that the Minister will receive the political support necessary to overcome the present across-the-board legal and regulatory impediments to rightsizing the public sector.

This impetus for reform at the Agriculture Ministry is doubly fortunate for USAID/Georgia as well as Georgian farmers, laborers, investors and consumers. First and foremost, it will position the Government of Georgia to take maximum advantage of the country's substantial potential to prosper from wise use of

the country's remarkable endowment of food and agricultural products. (More on this central economic growth opportunity in the section on strengthening the market chain -- Section B -- below.) Second, the Ministry of Agriculture, like the Tax Administration, could serve as a relatively manageable first step toward focusing and streamlining the entire Georgian public sector.

Recommendations:

- **Respond to the Minister's request and provide limited technical assistance on a phased basis, including expatriate and Georgian expertise, to support the downsizing and restructuring of the Ministry of Agriculture. The assistance should focus on:**
 - **determining the functions the Ministry should continue and developing policy, strategy and implementation plans for downsizing the Ministry in terms of staff and responsibilities;**
 - **developing a strategy and plan for the transfer to the private sector of selected Ministry assets and functions;**
 - **providing policy advice on day-to-day issues affecting the agricultural sector.**

- **The assistance should be provided in two phases. The first phase would be for three months with the second or follow-on phase extending for 24 months. Implementation of Phase II would be conditional on results achieved during Phase I and agreement with the Minister of Agriculture, as reflected in a Memorandum of Understanding, on the exact role and expectations for the USAID provided assistance during the Phase II period. The Phase II plan should be approved by USAID and the Ministry of Agriculture prior to proceeding with implementation of Phase II.**

B. Strengthening the Market Chain

The Assessment Team is unanimous in concluding that this is the perfect time for USAID/Georgia to put considerably greater effort into resolving the distortions and market failures that beset each link in the product-to-consumer "value chain." Without such direct, "hands-on" assistance, Georgians may have to pay an unacceptably high price in time and human misery while waiting for local entrepreneurs to take full advantage of the market opportunities offered by a liberalizing economy.

In short, a "bottom-up" initiative is needed to complement the primarily "top down" strategy USAID/Georgia has employed to date.

The bottom-up element of the strategy has in fact already begun, through USAID/Georgia's (and various other donors') numerous micro- and small/medium-enterprise promotion activities. Arguably, the two existing ACDI/VOCA activities (to build up a local seed industry and to establish farmer credit cooperatives) embody many of the characteristics of this bottom-up approach. A key to these efforts' success will be linking the productive potential of micro-and small-scale enterprises (including farms) with the demand for their products and services which must come " at least in great part " from larger wholesalers, processors, shippers, exporters and retailers.

The team is confident that, if any single sector stands out as possessing the potential to stimulate broad-based growth in Georgia, it is agriculture and its related complex of industries. The two final sections of this report propose a new agribusiness/farmer outreach activity, as well as related adjustments to the Mission's comprehensive new micro-small and medium enterprise program.

1. Agriculture and Agribusiness

a. Background

From almost any perspective the agricultural sector's current role in the Georgian economy is vital. In 1999, the sector (including agro-industry) contributed over 33 percent of GDP, or more than twice as much as any other sector. Employment in the sector is estimated to make up over 50 percent of total employment. Agricultural exports ranked second to metals in 1999 providing over 17 percent of total exports¹.

But these current figures may also be somewhat misleading. Agricultural output is down at least 30 percent since 1990 and labor productivity in agriculture has fallen even further as the sector has become the source of employment for thousands of unemployed from other sectors. The capital stock of farm machinery and processing equipment is generally in extremely poor condition. Food, drink and tobacco imports exceeded agricultural sector exports in value in 1998² while the production of value added products such as grape wine and canned food items using domestic raw materials has continued to fall. Most of the old state processing facilities no longer operate. Agricultural input use now is but a miniscule fraction of 1980's levels.

The troubled state of the agricultural sector reflects the need for action to resolve numerous constraints impeding market reform. The lack of tax reform, tolerance of smuggling and customs irregularities, the unavailability of financing and incomplete enterprise privatization and restructuring have created a situation where enterprises barely operate or are closed down. Of the 30 enterprises visited by the team, over 90 percent were closed and only a few of the remaining companies were operating at more than 10 percent of capacity. At the farm level the effect of this situation is a slide into subsistence production. If these issues are not addressed now, and with a sense of urgency, we can only expect the situation in agriculture to grow progressively worse.

Nevertheless, the assessment team believes there are real, quick pay-off and longer-run opportunities for positive developments and market-led growth in the sector. Georgia has the production potential to reduce import levels of some crops with domestic production (milk and wheat products) and to increase exports of higher, value added products that will expand internal markets for current and expanded domestic production of grapes, fruits and nuts in particular. The keys to success are a supportive business environment in Georgia and specific activities that will encourage local (and perhaps foreign) investment in viable production, processing and marketing activities.

b. USAID Agricultural Assistance

¹ The source of these numbers is the IMF Report of April 7, 2000.

² Latest year for which data is available.

USAID assistance to the agricultural sector, excluding land reform, has been modest. Earliest assistance was in the context of humanitarian aid and included provision of maize, wheat and potato seed, training and farmer-to-farmer volunteers. Internally Displaced Persons (IDPs) and small farmers in selected geographic areas were also targeted with inputs, credit, training and technical assistance³. Finally, a U.S. investor in wine processing received a small grant to cover a portion of the technical assistance, management and initial operating costs involved in the establishment of a joint venture.

More recently, through a grant to ACDI/VOCA, USAID has supported the development of the agricultural seed industry (wheat, maize, sunflower and potatoes) and the establishment of agricultural production credit associations. Under the seed industry assistance, a private seed company has been established that is currently producing and marketing potato, maize, wheat and sunflower seed. Limited continuing assistance to the company aimed at increasing its financial viability will end on September 30, 2001.

With USAID assistance, six production credit associations have been successfully established by ACDEI/VOCA and over \$900,000 in loans is currently outstanding. The repayment rate is almost 100 percent. USAID support for this activity will end September 30, 2000.

c. Problem Areas Facing the Agricultural Sector

(1) Policy

The agricultural sector suffers from the same set of constraints to an enabling business environment as do other sectors of the Georgian economy. Tax reform, customs reform, land reform, banking reform and other market reform requirements are critical if the agricultural sector is to grow.

Recommendation:

- **See other sections of this report for specific recommendations in each of these reform areas.**

(2) Farm Level Marketing

Under the previous system, marketing was handled largely by the state. This system no longer functions, and alternatives have been slow to develop leaving local producers with no readily accessible markets. The major decline in the processing industry (see below) has also meant a lowering of demand for some products (grape juice in particular). Surpluses of many fruits, vegetables and milk at the local level were evident to the assessment team and confirmed by local

³ Several NGO's continue to provide assistance to small farmers in specific geographic areas, often using funds from the monetization of USDA provided commodities.

producers. A limited number of efforts to provide a market for village production are emerging.

The Team visited a milk collection site in Dedoplistskaro, Kakheti that is serving 500 farmers. This product/market chain has put cash in this rural community and encouraged production and input use.

Recommendation:

- **Develop output market channels and strategies such as village collection points or local produce grading for specific markets. Contract relationships between processing plants and producers would be another method of providing markets.**

(3) Agricultural Input Supply

The old agricultural input supply system has largely collapsed and a new system suitable for a market economy has not yet emerged. Many inputs are no longer available, input suppliers that are active have yet to develop systems to reach small landholders, and small landowners lack resources to purchase inputs. However, the experience with farm stores of a CARE-supported activity in three districts of southern Georgia indicates that small landholders with a market for their products will buy some inputs. With other donor assistance an input ordering system organized by technical experts for mid-size farmers has worked on a modest scale in two other areas. This evidence suggests that lack of access to inputs may be the most important reason for their non-use in many areas. When farmers have the opportunity to procure inputs close to their farms they will.

Recommendation:

- **Establish a system of input supply at the village level through privately or cooperatively-owned farm stores, or through processors that are willing to provide inputs to help ensure a supply of raw materials for processing.**

(4) Processing Capacity and New Investment

Most agricultural processing facilities in Georgia are old and of a scale -- even if operating -- that makes them non-competitive. Only four of the 30 enterprises that comprise the Association of Food Processors of Imereti Region, for example, are reportedly operating, and only one of those on a regular basis. The Team visited flour mills, sugar plants, wineries and dairy processing facilities in other regions that were idle or operating at no more than 10 percent of original capacity. In short, only limited refurbishment, downsizing or new investment in the processing industry is taking place. Without additional processing investments, either local or foreign, marketing opportunities for many agricultural products will continue to be very limited.

Fortunately, there are also some good examples of local and foreign investments in a range of areas including fruit processing, flour milling and egg production that demonstrate the possibilities. A businessman privatized a large previously state-owned egg production facility, renovated part of the facility and is producing eggs for the Tbilisi market. He is looking for local sources of feed grains

but expects to have to import from Russia. An investor in Kutaisi has put a flour mill back in operation, established a bakery and is getting ready to invest in a new macaroni line. He also plans to import wheat to process. Milk and ice cream producers have imported modern equipment and use imported powdered milk because local supplies of milk are inadequate.

Recommendation:

- **Encourage processing of local products through a program that combines U.S. financial and technical assistance with additional processor investment on a matching basis.**

(5) Agricultural Extension

There are very few, readily identifiable sources of new technical and market information for farmers at the village level. However, the team is not convinced, based on conversations with farmers, that a lack of information on better agricultural practices is the key constraint they face at the moment. Apple growers, grape growers and milk producers all mentioned marketing and input supply not information as their biggest problems. Efforts to create sustainable fee-for-technical service systems by other donors have met with marginal success. In one case, input supply has been added to technical information to increase sustainability and farmer interest. The ability of the GOG to pay for a field-agent based extension service is also very problematic.

Recommendation:

- **The provision of extension information should be linked to farm stores and input suppliers and not be a stand-alone activity.**

(6) Agricultural Production and Processing Credit

A myriad of credit programs funded by various sources, including over 200 operating credit unions, provide a limited number of medium and small loans. Credit is not available for most agricultural producers. Interest rates of 15-30 percent or more under all the programs mitigate against any long-term loans.

USAID supports at least eight credit programs, including the ACDI/VOCA program. The ACDI/VOCA program was reaching over 800, mostly farmer, borrowers as of June 30, 2000. Interest rates were around 18 percent.

For agricultural processors, available sources of credit include commercial banks, the World Bank, IFC and the Agro Business Bank (recently founded by the European Commission). The USAID-funded ACDI/VOCA credit program also provides loans to small processors, but it is scheduled to end September 30, 2000.

Recommendation:

- **Take necessary action to ensure the ACDI/VOCA credit associations continue operating, perhaps under the auspices of the Agro Business Bank. Encourage any new agricultural assistance activity to work closely with the Agro Business Bank, and existing or new credit unions to identify and facilitate access to credit for producers and small landholders.**

d. Recommended Assistance Approach

While stimulating agricultural sector growth and development in Georgia will not be simple or inexpensive, the Team believes it is certainly possible and that USAID can have a significant impact. For the assistance to be effective, targeted inputs at several levels - producer, processor and exporter - are recommended. Such a multi-level approach recognizes that capitalizing on improvements in any single element of the agricultural systems chain often requires parallel improvements in other elements. The objective is to help create product market/value chains that facilitate the movement of inputs, information and agricultural products in upward and downward links between producers, processors and final distributors/exporters. (See the chart on the following page.)

Creation of such chains requires a coordinated and integrated package of assistance that addresses:

- the needs of farmers for access to markets and availability of the inputs needed to increase production;
- the requirements of processors and exporters for raw materials, and their ability to use those raw materials efficiently; and
- the ability of processors and exporters to accelerate investment.

There are four recommended elements in such an assistance package:

1. The establishment of **small farm stores** able to provide inputs and services to private farmers. These could be owned/operated by individuals, cooperatives, private companies or any mixture thereof.
2. The establishment of **service centers** that can act as wholesalers for farm stores, provide inputs directly to larger commercial farms and provide accessible markets for a variety of agricultural products at the village level via collection centers, authorized procurement agents or other mechanisms. These farm service centers would often be based around a processor or processing facility.
3. The **expansion of investment** by processors or marketing firms in new or renovated equipment and facilities. The primary focus would be on local investors with more limited emphasis on securing foreign direct investment.
4. The **development of domestic and export markets** for fresh or processed products.

[INSERT GEORGIA AGBIZ. TA SLIDE HERE.]

The assistance would be in the form of technical advice; grant financing on a matching basis with local businessmen, cooperatives or investors to set up farm stores, farm service centers and village collection or buying points; grant financing, again on a matching basis, for new investment by processors or marketing firms; and hands-on training. Limits would need to be set on the size of matching grants and explicit matching fund requirements established. Implementation would be via a Cooperative Agreement using Request for Applications procedures.

The Team estimates that the total cost of such a program over 3 years would be \$15-20 million. However, the program should be performance-based with a modest initial allocation of funds (\$3-4 million) with subsequent funding based on success in establishing farm stores, farm service centers, creating village collection points, encouraging new investment leading to additional domestic market demand, identifying and securing additional domestic and external markets, etc.

2. Micro and Small/Medium Enterprise:

Through both its economic reform and its humanitarian response programs, USAID/Georgia has been managing a series of US dollar and food aid local currency grants to a wide range of non-profit agencies to provide credit and business advisory services to micro, small and medium

scale entrepreneurs and farmers throughout Georgia. There are currently ten such initiatives under way. They include, among others, ADCI/VOCA (Agricultural Cooperatives Development), IOCC (Orthodox Church), UMCOR (Methodist Church), World Vision, IFRC (Red Cross), IRC (International Rescue Committee), Shorebank and FINCA, Constanta Foundation, and ADRA (Adventist Relief).

Though credit terms vary substantially, they tend to reflect market rates and average around 20-25 percent per annum. Collection rates are generally high. Most of the programs, however, have been operating for less than three or four years, and none has yet reached the stage of being self-financed or sustainable in the long term.

In part to address the sustainability problem, and also to strengthen the micro, small and medium industry (M/SME) sector more systematically, USAID/Georgia launched in early 2000 a more comprehensive program under contract with Sibley International (and various sub-contractors including the World Organization of Cooperatives and Credit Unions, WOCCU). The initiative has four principal components:

- legal and regulatory reform (via training and mobilizing concerned local associations);
- capacity building and technology transfer (by strengthening local consulting and business advisory firms and non-profit agencies);
- access to credit (through community-based savings promoted by WOCCU); and
- public education (by training journalists and advocacy groups).

The Sibley contract was signed in January 2000. The core team from Sibley International completed its baseline survey of the sector in July and is about to open the first of an expected four offices in secondary cities. Mobilization has been complicated by unexpected turnover among several key personnel, and WOCCU, as of early August, had yet to field its principal advisor.

In discussions with Georgian and expatriate managers of the various M/SME lending programs already under way, the majority noted how valuable it would be to address the more strategic needs of the sector by strengthening its legal/regulatory, advocacy, and business consulting infrastructure. There were several expressions of concern, however, that a small-scale, community-based credit union approach to savings and capital mobilization could prove problematic. In summary, two questions may be worth considering regarding the credit access component of the Sibley program:

- In Georgia's current stagnating economic and commercial environment, how helpful or substantial will village-level savings mobilization prove to be in enabling micro and small enterprise start-ups; and
- What relative priority would such an approach have compared to other investments such as generating stronger market demand for micro and small/medium enterprise products and services?

On balance, the team supports the broad-based approach to the M/SME sector that the Mission is undertaking. Its focus on agricultural and rural enterprise promotion also seems entirely appropriate. In addition to the strong emphasis on developing market/value chains in agribusiness outlined in the previous section, it would seem advantageous indeed for USAID/Georgia to continue investing in strengthening capacity in other promising M/SME sectors.

Recommendations:

- **The various considerations and questions above suggest that USAID/Georgia may wish to take advantage of the opportunity offered by WOCCU's mobilization delays to reassess the relative need for this component at this time.**
- **In a similar vein, the team noted that other USAID-funded activities in the economic reform portfolio, notably the land privatization effort, include sub-contracts to address public education and media strengthening efforts. USAID/Georgia may wish to consider consolidating this type of assistance in the hands of only one or the other of these partners.**
- **Finally, USAID and the Sibley team could consider identifying particularly promising M/SME sub-sectors (i.e.: tourism, light manufacturing of parts or components for larger industry, crafts etc.), on which to concentrate the program's efforts.**

Annex I: List of Contacts

Government of Georgia

Deputy State Minister – Giorgi Gachechiladze
Minister of Agriculture – David Kirvalidze
Minister of State Property Management – Micheal Ukleba
Minister of Revenue – Michael Machavariani
Minister of Finance – Zurab Nogaideli
Minister of Economy – Vano Chkhartishvili
State Department of Land Management – Zurab Gegechkori, Head
Parliamentary Committee on Agriculture– Bezhan Gonashvili, Chairman
Parliamentary Committee on Economic Policy & Reform – Vano Merabishvili, Chairman
National Bank of Georgia – Irakli Managadze, President
Land Registrar’s Office in Kutaisi
Georgian Investment Center – Saba Sarishvili

Enterprises (Private & Public)

Tbilisi

Bread Co. Temka, Tbilisi – Soso Kukhianidze
Amaltea – Dairy Company
Samgori – Dairy, spirits, advertising – Sandro Kintsurashvili
Nikora – Meat Processing
Sante Walsh - Dairy Processing
Lilo Fruit Juice Co.
Nana Chikaidze, Gia Tsintsadze (Photo shop) – Shorebank client

Rustavi

Rustavi Metalurgical Plant - Nodar Gvamberia
Pelagia Suanidze (Trade) – Shorebank client

Kutaisi

Metropolisi (Bakery) – Gela Gagua, Shorebank client
Mill/Silos/Bakery – Murad Tsivtsivadze
Paizi Mineral Waters – Parvis Berekashvili, Deputy Director
Electromekanikosi (summersable oil engines, pumps) – Archil Murgulia, Bakur Balanchivadze
Medea (textile) – Merab Kenhcadze, Sergo Pakhuridze
Saqtraqtori (ag. machinery) – Zurab Tavdumadze and Murman Mamrkisvili
Litoponi (paint) – Valeri Manjgaladze, Robert Barabadze, Dir.
Airplane Manufacturing Plant - Khatchapuridze’s

Dedoplistskaro (Kakheti region)

Oilseed Processing Plant
Alpha Laval Milk Collection Point
Cheese Production Plant

Other locations

Flour Mill “Elita” in Gori – Gela Kodlashvili
Sugar Plant in Agara – Alexander Gigitashvili
Ksani Botling Co. – Abdulah Kelench
Poultry Farm in Patardzeuli (Kakheti) – Niko Nebieridze
Horizon Seed Co. (Kakheti) – ACDI/VOCA
Flour Mill in Kachreti
Chalice Wines
Potato Seed Production Company in Marenuli
CARE Irrigation, Seed Production and Input Supply in South Western Georgia

Donors

IMF – Chris Lane, Resident Representative
World Bank – Tevfik Yaprak, Resident Representative
World Bank Agricultural Sector PIU @ MoAg – Giorgi Maglakelidze
KfW – Benno Arnolli
IFC – Lisa Kaestner
EBRD - Kevin Cain

Implementing Partners

Barents Group/Capital Markets –David Wall and Matthew Zimmerman (SROs' business plans)
Barents Group/Enterprise Privatization – Tom Allen
Barents Group/Tax & Fiscal Reform – Peter Muir and Craig McPhee
Booz Allen & Hamilton/Banking Supervision – Terry Stroud
Booz Allen & Hamilton/Land Market Reform – Bob Cemovich
Sibley/Accounting Reform – Wayne West
Sibley/SME Development – Will Cain
ACDI/VOCA – Michael Colgrove, Rusty Schultz and Hugh Brown
CARE – John Perry
CERMA – Sandro Khizanishvili
Overseas Strategic Consulting, Ltd. - Robin Johnson and David Neubert
Citizens Democracy Corps - Aaron Bornstein

Other

U.S. Ambassador - Kenneth Yalowitz
U.S. Embassy POL/ECON Officer – Sandra Clark
USAID – Michael Farbman/Dir, David Mandel/PPS, James Watson/ER, Barry Burnett/EE/MT, Geoffrey Minott/ER, Amy Heinen/ER, Nicole Jordania/HR, Herbert Emmrich/EE and Georgia Samburnaris/EE/MT
U.S. Treasury – Regis Chapman, Budget Advisor to the Ministry of Finance
ITS (customs) – Neville Bissett
American Chamber of Commerce – Fadi Asly
Agro-Business Bank of Georgia – Peter Shaw and Michael Mgaloblishvili
Investment Fund Caucasus Advisors
GIA Investment Co. – Gogi Loladze, Ilya Khmaladze
Production Credit Association in Gori - ACDI
Production Credit Association in Telavi - ACDI

Non Governmental Organizations

Association for Protection of Land Owners Rights (APLOR) – Jaba Ebanoidze, President
APLOR Kutaisi Branch – Merab Baratashvili
Food Processors' Association (in Kutaisi) – Murad Tsivtsivadze
Business Support Center (in Kutaisi) – David Khurtsia, Tamaz Mikadze, Temuri Ukleba
Group of Humanitarian NGOs – ADRA, IOCC, IRC, UNOCHA, Red Cross Federation, UMCOR, Save The Children, Constanta, and Counterpart

Presentations

Farmer Land Survey by OSC (Public Education Contractor)
SME Baseline Survey by Sibley Int. (SME Development Program Contractor)
Rapid Assessment Survey by Save The Children

Other Activities

Land Titling Ceremony in Kaspi

Day w/ Gonashvili in Kakheti - Dedoplistskaro, Kachreti, silos/mill, new vinery, farmers

Land Registration Office Visit in Kakheti (Gurjaani and Telavi)

Visit to Tskhinvali, North Osetia

Visit to South West Georgia with CARE

Annex II: Team Schedule

July 18, Tuesday

- 9:30 Meet with USAID Staff
- 1:30 Lunch w/ Sandra Clark, Embassy POL/ECON Officer
- 3:00 Bread Co. Tbilisi, Temka
- 5:00 USAID - Michael Farbman/Dir, David Mandel/PPS, James Watson/ER, Barry Burnett/W/E&E

July 19, Wednesday

- 8:30 Leave from Guest House
- 9:30 Flour Mill "Elita" in Gori
- 10:30 ACDI/Credit Association in Gori
- 12:00 Lunch @ "Venice"
- 1:30 Sugar Plant in Agara
- 3:30 Land Titling in Kaspi
- 4:00 Ksani Bottling Company
- 6:00 Minister of Agriculture

July 20, Thursday

- 9:00 Capital Markets SRO's Matt Zimmerman
- 10:30 Amaltea –Dairy Company (Barents Privatization/Financing)
- 12:00 Parliament Agricultural Committee – Bezhan Gonashvili, 922089
- 1:00 Lunch w/ Jaba Ebanoidze of Association for Protection of Land Owners Rights
- 3:30 Deputy State Minister – Giorgi Gachechiladze
- 5:00 Samgori – dairy, spirits, advertising (BG Privatization) Sandro Kintsurashvili
- 5:00 Walter - McPhee

July 21, Friday

- 8:00 Depart for Dedoplistskaro, Kakheti
Visit Kachreti silos/mill, winery, oilseed processing facility, cheese processing plant and land registry office.
- 6:00 Return to Tbilisi

July 22, Saturday

- 8:30 Leave for Kakheti and visit to Horizon Seed Co.
Visit Production Credit Association in Telavi, production fields and leased facilities.
- 7:00 Return to Tbilisi

July 24, Monday

- 8:30 UST - Regis Chapman @USAID
- 10:00 Tom Allen – Barents Group/Privatization @ MSPM
- 11:00 Minister of State Property Management – Micheal Ukleba @ MSPM
- 1:00 Minister of Revenue – Michael Machavariani @ MoR
- 2:00 Giorgi Maglakelidze, WB Ag. Sector @ MoAg
- 3:00 Zurab Gegechkori – State Dept. of Land Management @ SDLM
- 3:00 ITS – Neville Bissett @ USAID
- 4:30 Peter Muir - Barents Group/Tax Reform @ USAID
- 4:30 John Perry, CARE @ CARE
- 6:00 Vano Merabishvili, Chairman, Parliamentary Committee on Economic Policy & Reform @ Parliament

July 25, Tuesday

- 9:00 Farmer Land Survey @ OSC
- 10:00 Terry Stroud – Booz/Banking Supervision @ NBG
- 11:00 National Bank of Georgia – Irakli Managadze @ NBG
- 2:00 Wayne West – Sibley/Accounting Reform @ Sibley
- 3:00 IMF – Chris Lane @ Chancellery
- 4:00 SME Baseline Survey @ USAID
- 6:00 Vano Merabishvili @ USAID
- 6:00 Minister of Finance – Zurab Nogaideli @MoF

July 26, Wednesday

- 9:00 Agro-Business Bank – Peter Shaw
- 10:00 Ministry of Revenue
- 11:00 Georgian Investment Center @ USAID
- 12:00 Nana Chikaidze – Shorebank client

Rustavi -

- 2:00 Pelagia Suanidze – Shorebank client (Trade)
- 3:00 Rustavi Metalurgical

July 27, Thursday - Kutaisi

- 7:00 Leave from Guest House
- 10:30 Food Processor's Association in Kutaisi,
Mill/Silos/Bakery - Murad Tsvitsivadze
- 12:00 SME – BSC, David Khurtsia, Tamaz Mikadze, Temuri Ukleba;
- 2:00 Association for Protection of Land Owners Rights, Merab Baratashvili, 587094;
- 3:00 Registrar's Office
- 2:00 Paizi Mineral Waters
- 2:00 Electromekanikosi (summersable oil engines, pumps),
- 3:00 Medea (textile)
- 3:00 Khatchapuridze's Airplane Plant
- 4:00 Saqtraqtori (Ag. Machinery)
- 4:00 Litoponi (paint)
- 5:00 Depart to Tbilisi

July 28, Friday

Field Visit to Gurjaani - meet with local registrar and SDLAM representative
Field Visit to Telavi - attend APLR meeting on draft unallocated land distribution law and visit
ACDO/VOCA credit client at fruit processing plant
Field Visit to Tskhinvali and discussion with farmers
Poultry farm in Patardzeuli - Niko Nebieridze

July 29, Saturday

- 8:00 Field visit to Dedoplistskaro
Visit Alpha Laval Milk Collection Point
Talk to farmers
- 2:00 Return to Tbilisi

July 31, Monday

- 1:00 Minister of Economy – Vano Chkhartishvili @ MoE
- 3:00 Fadi Asly – American Chamber of Commerce @ USAID

August 1, Tuesday

- 9:00 Barents Group/Privatization
- 1:00 Michael Farbman, David Mandel and Earl Gast @ USAID
- 3:00 Ambassador Yalowitz @ Embassy

August 2, Wednesday

- 10:00 Humanitarian NGOs
- 12:00 CM SRO's – Matt Zimmerman @ USAID
- 3:00 Peter Shaw – Agribusiness Bank
- 4:30 World Bank – Tevfik Yaprak
- 5:30 Ministry of Agriculture

August 3, Thursday

- 8:00 Field Visit with CARE to South West Georgia
- 10:00 Nikora – Meat Processing
- 12:00 CERMA – Sandro Khizanishvili, Dy Executive Director.
- 2:00 Field visit to Potato Seed Production Company, Marenuli/Bolinisi
- 2:00 Investment Fund – Caucasus Advisors
- 4:00 GIA Investment Co. – Gogi Loladze, Ilya Khmaladze.

August 4, Friday

- 10:00 Booz Allen/Land Market Reform, Dato Arsenishvili @ Parliament
- 11:00 Georgia Stock Exchange
- 11:30 Sante Walsh Dairy Plant
- 12:30 Agro-Business Bank
- 2:30 Save the Children

ANNEX III: Fiscal Reform Update

To: Geoffrey Minott
James Watson

From: Sharon Hester

Re: Georgia fiscal reform activity

Date: July 10, 2000

I. Background and Summary

This is a report from a two-week trip to Georgia during June 23 to July 7, 2000. A purpose of the trip was to assess the progress of tax administration reform under the Memorandum of Understanding signed on March 8, 2000 (MOU). A second purpose was to assess and make recommendations on the status of tax reform in Georgia in the context of Georgia's overall market reform. Conclusions of this report are drawn from examination of laws, advisor reports, an on-site inspection of the Large Taxpayer Inspectorate (LTI), and interviews.

The current task order for fiscal reform (Phase II) extends through September 2001, and will fund about \$6.9 million of activities, including \$1.5 million of computers for the tax administration. The main components of the task order are tax administration (including computerization and training), tax policy (writing regulations for the main taxes), macroeconomic assistance to the Ministry of Finance and budgetary assistance to the Parliament.

On the revenue side, Georgia's revenue collections are very low at around 10 to 11% of GDP. The main problem does not appear to be the tax law, but rather the way it is administered. Specific administrative problems are corruption, inefficiency and "predatory" procedures. Tax liabilities are often negotiated, bribes are common, and businesses not registered with the tax administration often pay amounts to tax inspectors instead of paying taxes. The corruption and inefficient procedures have resulted in extremely low tax collections. Low tax collection in the tax department also results from low understanding of tax law on the part of tax inspectors. The tax department is also arbitrary and heavy-handed in its actions toward taxpayers, creating negative attitudes and serious problems for taxpayers.

Currently, a predominate reason for low collections is the low level of collections by Customs (which should be collecting about half the revenue). Rather than improving, Customs collections appear to be getting worse. The tax department has made some improvement in tax collections over the past year; however, progress collections made through the tax department is offset by decreases in Customs revenue. Large amounts of gasoline and diesel are being smuggled into Georgia and there seems to be a lack of will on the part of Customs to tackle this issue. In fact, in recent months, these collections have dropped precipitously. Tax avoidance by these taxpayers creates serious problems for legitimate businesses that have difficulty competing with the lower prices of

smuggled goods. It is doubtful that the government of Georgia can significantly raise tax collections without addressing the issue of low collections by Customs.

On the expenditure side, the Ministry of Finance has low capacity for estimating revenue or for tracking expenditures. There is also apparently a great deal of “leakage” in the process of transferring revenue to the spending agencies and along down the line to the end recipients.

II. Current Environment and Technical Assistance Activity

A. Tax policy

There are many areas for improvement and refinement to the Tax Code, both in tax policy and tax administration; however, overall, the tax law forms a sound basis for taxation and does not appear to be the main problem in the taxation system. Although the overall tax burden is high, it is not higher than other similar countries in transition, and the penalties and interest are not higher than other similar countries. The often-heard complaint that tax is the main impediment to business in Georgia appears to stem from problems with the tax administration at least as much as from issues concerning the actual taxes.

The Tax Code has been amended often, creating uncertainty for both administrators and taxpayers; thus, changes to it should be limited. However, changes that would simplify the system without reducing revenue should be considered. For example, consideration should be given to recommendations that the presumptive tax apply to all small businesses, replace all other taxes, function as a final tax, and changing the threshold of the VAT to be consistent with the threshold for the presumptive tax. This change should simplify the payment of taxes by small businesses who are often unsophisticated and have a low capacity for compliance; further, the tax department does not have the capacity to audit and collect a profits tax from these businesses. Recommendations for a presumptive land tax for farmers should also be considered. Nuisance taxes should be eliminated, such as the tax on economic activity, advertisement tax and tax on transfer of property. Before recommending these tax law changes, however, revenue forecasting should be done to estimate the revenue implications.

B. Tax administration

Taxes are not administered in a fair, efficient or professional way. This results in low revenue collection and a large shadow economy. It is likely that 80% of the small and medium businesses are not registered as taxpayers, creating the problems of a small tax base and increased pressure on compliant taxpayers. Problems with tax administration result in major problems for taxpayers and present serious impediments to business. The tax department also lacks capacity in understanding and interpreting the tax law.

The main focus of fiscal reform is the reorganization of the tax administration according to the MOU. Although progress in the reorganization has been stalled, it appears that this will be moving forward and can still be completed by the end of the activity (September 2001). Implementation of the reorganization was delayed because of delays in signing the MOU and changes in the Government of Georgia. A new ministry, the Ministry of

Revenue, was formed and the new minister is supportive of reform and the MOU. However, the new minister was not empowered with the authority to staff the new ministry and proceed with reforms. This authorization recently occurred. There has also been some resistance to the reorganization plan from the tax department, particularly as to the testing and reduction in staffing. However, at this point, resistance has been countered and the date for the first testing of tax department staff has been set for August 4, 2000. The new ministers, the Minister of Finance and the Minister of Revenue, are very supportive and intend for the reorganization to occur as planned. The reorganization plan per the MOU is well-conceived, comprehensive and should result in a more professional and knowledgeable staff, better procedures, lessened corruption, and improved collections over time. The US Treasury is working on establishing an internal audit function, which will also help to reduce corruption.

The advisors have been working on other tasks in preparation for the reorganization, including working with implementation teams, public education, computerization, and strategies for increasing the collections of social tax and the presumptive tax. There is little incentive to collect the social taxes because the revenue quotas (explained below) apply to collection of taxes such as the VAT, excise and profits tax that will go into the budget. The social taxes go into a separate fund and the tax inspectors have little incentive to collect these. Overpayments of “budget” taxes such as VAT or profits tax, are not applied against social taxes arrears. Advisors are suggesting solutions to this problem.

Advisors are working with the enforcement teams on collection of taxes on gasoline, diesel and cigarettes. Part of the enforcement strategy is public education that illegal contraband may be seized, as well as the vehicles used in transport. The advisors are attempting to bring three groups together to cooperate in the white oil enforcement teams (tax inspectors, tax police, customs). They are also working on a recent problem of fraudulent VAT invoices used by taxpayers to obtain fraudulent tax refunds. On the expenditure side, an advisor is working closely with the Minister of Finance to begin documenting and analyzing government expenditures.

This report does not recommend improvements to the current plan, other than to recommend future assistance after the reorganization is completed. Instead, section D explains some predominant problems that currently make taxes an impediment to businesses and what is being done or needs to be done to address these problems. Main issues raised by taxpayers include the uncertainty of the tax system, general “harassment” through audits and collection procedures, the practice of freezing taxpayer bank accounts, high interest and penalties, fees and requirements that are not related to taxation but have been tied to it (thus complicating the tax system and presenting obstacles to compliance), and low understanding of tax law by tax inspectors.

C. Budget

Advisors, including the US Treasury, are working with the Ministry of Finance and Parliament to improve budget laws, forecasting ability, and the formulation and execution of budgets. This work is extremely important, not only to improve the budget process, but to improve the tax system. Inflated revenue estimations are used to create revenue

targets and quotas for the tax administrators. These targets result in pressure on taxpayers to make advance payments of tax.

D. Specific tax administration problems and recommendations

1. Eliminate collections based on “quotas” according to a “Plan”. The tax department is collecting amounts that it is required to collect per orders of the Ministry of Finance (quotas per a “Plan”). These are also called “advance payments”. The tax department does not assess tax liabilities; rather, it collects the advance payments. It is viewed by taxpayers as “predatory” in these collections. The head of the LTI along with heads of other tax inspectorates have a practice of calling taxpayers on a monthly basis and demanding “advance” payments. The amount demanded is not based on what the taxpayer owes and in fact may have little relationship to the legal liability, but is simply the amount the LTI needs to meet its quotas. These advance payments are later applied against the taxpayer’s tax liability; however, the practice is unfair to taxpayers. At times, the practice results in an overpayment, and at other times it results in an underpayment of tax. An underpayment occurs because the taxpayer may negotiate to pay a lesser amount of tax due. An overpayment occurs if the taxpayer feels forced to pay an amount that is more than the amount due and is later unable to receive a refund. For example, the taxpayer may feel forced to pay the amount demanded because there is an implication that non-cooperation will later result in difficulties at the audit stage whereas cooperation now will mean an easier audit. An advisor is working with the Ministry of Finance to encourage more realistic revenue projections. This should have the effect of lessening the pressure to collect these advance payments. However, more direct intervention is needed, such as a direct order at the ministerial level to discontinue the practice of demanding advance payments. The advisors are pursuing this avenue.

2. Eliminate the bonus payment system. Tax inspectors in the LTI have not been paid salaries in about 8 months; they are currently paid on a bonus system whereby they get a percentage of tax and penalties collected. This provides them with between 400 to 450 lari per month. It is an incentive to collect penalties and a disincentive for them to work with the taxpayers to obtain the correct tax, or to compromise a tax liability (even in cases where a modern tax system would encourage a compromise). The tax reorganization will improve this situation.

3. Improve the appeals system. The law provides for an administrative and judicial appeal system but the reality is that it does not work well. For example, only a very high official is able to compromise a tax liability, resulting in an extremely inefficient and in fact mostly unworkable administrative appeal system. The courts are very slow and corrupt; thus many taxpayers do not view appeals as a viable recourse and feel compelled to settle a dispute with bribes. Suggestions for improvement include documenting the current administrative appeals procedures, pursuing changes to these procedures to allow lower level employees to compromise a tax liability, and establishing a panel of judges who will specialize in hearing tax cases, with possibly expedited procedures for small tax cases (i.e., under a certain amount).

4. Encourage greater certainty in the law. From the taxpayer point of view the tax system is characterized by great uncertainty—both as to the tax law and as to the way it is administered. First, the tax laws may change often and without adequate advance notice.

Second, the tax law is unclear and there are inconsistencies. Regulations drafted by foreign advisors should help this situation in the short-run. However, many issues arise in interpreting tax laws and it will take time to mitigate this situation. Advisors have recommended allowing changes to the tax law only once a year.

5. Mitigate the “harassment” felt by taxpayers. A taxpayer may be audited by numerous agencies, including more than one tax inspectorate, and by additional agencies, including the tax police, the economic police, the local traffic police (who check taxis for stickers showing they have paid the presumptive tax), and others. The tax administration may audit numerous times in one year, and extract tax payments (in reality bribes) on each occasion.

6. Improve the LTI. This will require assurance that the composition of taxpayers controlled by the LTI is based on the correct criteria, as well as special attention to improving procedures.

7. Consider improvements to certain penalties. It does not appear that the penalties distinguish between negligent and willful behavior; it is important to make this distinction, with a larger penalty for willful behavior. The application of penalties is problematic in transition countries because often penalties are applied against legitimate businesses that are trying to comply rather than against non-compliant taxpayers. The tax inspectors use penalties to extract payments for “administrative” or negligent offenses rather than as a means of discouraging non-compliant behavior. Thus, it may be helpful to consider whether the following penalties need to be lowered: (1) Art 218(7) (AmCham and Barents have recommended changing), (2) Art 254, penalty of 50% of the unpaid tax for substantial understatement of tax, applies where the underpaid tax is 2000 lari or 25% of the tax (the 2000 lari threshold may be too low for a large business), and (3) Art. 273(24) unregistered presumptive taxpayer must pay 12 times the tax.

8. Consider how to mitigate the effect of high interest rates. Study whether the interest rate for late payment of tax can be reduced to a more reasonable level or capped, while at the same time discouraging abuse of the lower rate. The interest rate is 0.2% per day, resulting in an annual rate of over 70%. The cost of borrowing at a bank is 30 to 40%. If the interest rate on late taxes is lowered, then a taxpayer will have the option of using non-payment of taxes as a way to borrow money at a lower interest rate. However, this high interest rate is harsh, given the difficulties taxpayers face in using the appeal system. The interest and penalties can end up being more than the tax and can put a taxpayer out of business. While penalties and interest can be higher than the tax in a Western tax system, there are important differences between a well-developed and underdeveloped system. In an undeveloped country, the tax system is characterized by uncertainty in the tax law, sometimes unreasonable demands by the tax department, and an undeveloped appeals system. The combination of these conditions mean that a taxpayer trying to comply may nevertheless have to pay a tax along with penalties and high interest. It would be preferable to impose a more reasonable interest rate to avoid putting taxpayers out of business.

9. Improve access to information by small and medium businesses. Owners of small and medium businesses do not know all the legal requirements for doing business; thus, they learn as they go, resulting in fines for noncompliance and continual impediments to

getting a small business going. Tax forms and informational literature are not easily accessible to taxpayers. These businesses need to have an easy way to register as taxpayers and should have easy access to all the requirements for engaging in their particular type of business.

10. Work with the banking reform activity to consider changes in the law to prevent the tax department from freezing bank accounts without adequate due process. Taxpayers complain that the tax department is able to freeze bank accounts arbitrarily and without adequate due process. This presents problems not only for taxpayers but also for the banking system in that it may affect the credibility of the banks.

III. Future needs

Developing a modern tax administration is a long-term activity. Conventional wisdom is that it is preferable to take the necessary time to develop a modern and sustainable system, than to attempt ad hoc emergency measures. A smooth-running and efficient system with a professional cadre of tax administrators is an essential part of the enabling environment for a market economy and for changing the public perception of the tax system. Thus, the current tax reform activity is the correct way to proceed. Assuming the reorganization of the tax administration occurs on schedule and as planned, there will need to be a follow-on activity to sustain and further the reforms. Without a follow-on activity, the tax department will almost surely revert to much of its former structure and methods. Closed offices may be re-staffed, overstaffing in all offices may resume, and computerization may halt.

The tax reorganization will lay extremely important groundwork for the modernization of the tax department; however, it is only a beginning. The managers need to be instructed on how to formulate plans for administering the taxes. A training center is being established, but much follow up will be needed to instruct tax inspectors in their various tasks, including substantive knowledge of International Accounting Standards, the tax reconciliation form and complicated tax issues, so that they are knowledgeable and professional. This will not be accomplished quickly, but the development of professional and knowledgeable employees is essential to a modern tax administration. The internal controls department that US Treasury is working on will need continued assistance.

The computerization at the end of the current activity will not be complete. Additional functions will need to be installed, such as additional modules to cover all the taxes (the current computer modules will cover only the main 4 taxes). Further computerization will be needed for audit selection, an extremely important function, and additional collection functions will be needed, such as prioritizing collections based such factors as age of arrears.

Assistance in tax policy for improvements in the law, to prevent backsliding and also for additional work on drafting regulations will be necessary. The regulations on the main taxes, along with regulations and manuals for audit and collection are key to putting some certainty into the tax system, making the tax department more efficient and reducing the arbitrariness of the system.

Continued assistance to the Ministry of Finance in budgeting is essential for getting expenditures under control and for establishing some transparency into the spending.

The development of a property tax will be essential to fund local government activities, and should be part of a future activity.

The need for public education about taxes cannot be overstated as it is essential to creating an atmosphere of compliance.

When the environment is right, institutional reform of Customs is critical to increasing revenue and also for improving public perceptions about the tax system.

List of interviewees:

Barents advisors:

Peter Muir

Sam Greer

Eddy Koos

Craig McPhee

Gibbie Porcari

Catherine Irvine

David Crawford

Harry Trouche

Valerian Davituri (Head of LTI)

Neville Bissett (ITS)

Fady Asly (AmCham)

Chris Lane (IMF)

Preston Benoit (UST)

Regis Chapman (UST)

Irina Topuria (Ernst & Young)

John Edwards (AES-Telasi power company)

Nino Marshiania (GSG Audit/Arthur Anderson)

Elmira Toglatti (Survey administrator for Sibley SME activity)

Kristen Hayden (Marriott)

William Bateson (economist)

Robin Johnson (public education activity)

ANNEX IV: Banking

**Laurie Landy
USAID Wash/EE/MT
July 2000**

GEORGIA STRATEGIC OVERVIEW OF BANKING PROGRAM

I. A SNAPSHOT OF THE BANKING SYSTEM

In common with many other countries of the former Soviet Union, the Georgian banking sector plays a very limited role in resource mobilization and intermediation between savers and investors. The basic indicator of banking sector depth, broad money to GDP is an estimated 8 percent - - low, even for countries of the former Soviet Union. Deposits in the banking sector are equal to less than 4 percent of GDP, of which household deposits are about 1 percent.

Moreover, the banking sector largely conducts business in foreign currency because of lack of confidence in the domestic medium. Particularly since the August 1998 Russian crisis, dollarization has risen. Currently, about 80 percent of deposits and a similar amount of banking assets are denominated in foreign currencies.

The reasons for this disappointing performance are common to many countries spawned from the Soviet Union. Lack of confidence in banks, and consequent low level of bank deposits reflects, among other things: a) confiscatory currency redenomination in the last days of the Soviet Union; b) hyperinflation in 1993/94 which wiped out savings; c) bank insolvencies over the last few years where there is no deposit insurance; d) the large size of the informal economy; e) reticence to be exposed to the tax authorities.

Banks are not intermediating too for familiar reasons. In common with many former Soviet Republics, real interest rates in Georgia are very high -- roughly 35 percent for short-term loans.¹ Other important factors include: a) insider lending, cronyism and corruption which usurp resources, b) difficulty valuing collateral in thin markets with ineffective collateral laws, registration, title clarity and collection procedures; c) after August 1998 reserve requirements were raised 4 percentage points to a high 16 percent, limiting banks' scope for less liquid asset expansion.

And fundamental, is the lackluster economic performance. Vigorous economic growth, while not a panacea, is a necessary condition for increasing the role of the banking sector in both resource mobilization and financial intermediation.

¹ The high level of real interest rates reflects a sizeable risk premium given difficulties in assessing risk and foreclosing credits in Georgia's difficult economic environment, and also factors in inflationary expectations. The interest rate spread between short-term loans and deposits is a high 20 percentage points. This is a result, among other things, of the large share of non-performing loans and other illiquid assets in banks' portfolio, the small scale of individual bank operations (which limit scale economies), and the high operating costs for a variety of reasons (such as time consuming government reporting requirements).

Besides common elements with other former Soviet Republics, three additional factors make the situation in Georgia particularly challenging. First, political problems beset the country, both because of domestic regional fractures and because of the fallout externally on Georgia's borders as the Russian hinterland disintegrates. Neither foreign nor domestic investors can be expected en masse, given such substantial political uncertainties.²

Second, is pervasive corruption -- Georgia consistently is among the worst in surveys of former Soviet Countries. The banking system is hardly isolated from this. Reportedly, bank officials benefit financially from individual transactions. Additionally, the banking system is believed to be rife with insider lending.

Finally, Georgia is a small country with a limited internal market and a relatively sparse natural resource endowment. This configuration suggests that Georgia will have to depend upon international trade (both manufactures and agriculture) and services (tourism, transit) to flourish. Integrating into the international economy, however, is an extended process. It involves, among other things, revamping and modernizing the industrial structure inherited from the Soviet Union and developing new trading arrangements. Any benefits from the proposed pipeline too would take time to materialize.³

While the above situation is not intractable, it is extremely difficult. Substantial patience will be needed because, more than likely, discernable improvement will become evident only over an extended period. But, for the foreseeable future, banking opportunities are sharply circumscribed, given the economic and political context.

II. USAID'S TECHNICAL ASSISTANCE PROGRAM

Development of the banking infrastructure, as elaborated below, is still very much at the beginning. Western banking skills similarly, are greatly in need of refinement. Given this view, USAID's technical assistance program is still focused on strengthening the fundamentals, the basic building blocks of a banking system. These fundamentals, while not sufficient, are certainly a necessary condition to gradually build public confidence in the banking system. Until businesses and households feel more assured that there is greater safety and soundness in the banking system, they will continue to avoid the banks.

The USAID technical assistance program is of recent vintage. Bankers training assistance, as well as support to the National Bank of Georgia (NBG) in developing the electronic funds payment system only began in 1997. Bank supervision support to the NBG started in late 1999. A bank accounting and risk management project was added in June 2000. The Financial Services Volunteer Corps (F.S.V.C.) started its program in May 2000, focusing on bank supervision and the electronic funds payments system.

² There are two fully owned foreign banks, a Turkish and an Azerbaijani. Additionally there is a new Micro Finance Bank and a new Black Sea Bank capitalized by non-private foreign entities. No large western bank, however, currently has branch operations in Georgia.

³ The small size of the country and limited opportunities for business is another factor discouraging large international banks from opening branches. Ukraine, for example, a country with a consistently lackluster economic performance and little structural reform, but with roughly 50 million people and relative political tranquility, has been able to attract ING, Citibank, Deutschebank, Credit Lyonnais and Societe Generale, among others.

SUMMARY: The bank supervision department still lacks the expertise to adequately analyze the financial condition of banks. Accounting and legal reforms are urgently needed to give the supervisors accurate information and enforcement powers, and will be a focus of USAID technical assistance over the next eighteen months. Bankers' skills too need substantial further development. We are in the process of redesigning and rethinking our approach to bankers training.

II.1 BANK SUPERVISION

There are basically three guarantors of the safety and soundness of the banking system - - the market, the management of the bank, and the government's bank regulatory authority. In the early days of banking sector development market forces are very weak, and the management is too often unable or unwilling to exercise prudent authority. Thus the task will fall in these early times overwhelmingly on the shoulders of the bank supervisory authority.

For a number of years the IMF has provided a technical advisor to the NBG Bank Supervision Department (BSD) and modest progress has been made, particularly given the starting point since there was little foundation from the Communist system to build upon. A structure exists and prudential regulations are just beginning to conform to international standards (although much more work is needed), on-site examinations take place with regularity and an off-site analytic system is being used. Thus, some of the mechanics are in place but the NBG Supervision Department is still very much in the first stage of its development.

Under the NBG Supervision Department's guidance progress had been made in consolidating the banking system. During 1996-1997, as part of the NBG restructuring program, all banks were required to develop business plans and reform strategies for a NBG certification committee. Banks, not certified, had their licenses withdrawn. Additionally, during the restructuring program, the BSD placed restrictions on operations of four larger former state banks. Substantial changes took place in these Gosbank spin-offs, including closing of unprofitable branches, pursuing more aggressively overdue loans, improving (somewhat) loan-loss provisioning, and reducing staff. The share of these former state-banks continues to shrink, currently accounting for only one-third of total banking assets.

Today the Georgian banking system consists of 34 banks. Although much improved from 230 banks during the mid-1990s, in the current environment there still simply is not enough viable business to support this many banks.

In the aftermath of the August 1998 Russian crisis the NBG displayed considerable agility. The Central Bank's actions are widely credited with avoiding a major liquidity crisis. The NBG assessed the liquidity situation of the largest thirteen banks every ten days. Memoranda of Understanding with this group limited new lending, required agreements and plans for enhanced loan collections, and limited off balance sheet items, among other things. Inspectors were placed in the largest institutions to monitor daily activity. Thus, the NBG Bank Supervision proved its mettle during a crisis and also acted aggressively earlier in the decade to put the banking system on a somewhat sounder footing (unlike several other former Soviet Republics which have taken little, if any initiative).

Nevertheless, as noted earlier, further technical assistance is still needed to give the NBG supervisors skills necessary to adequately analyze the financial condition of a bank. Not surprisingly, given the length of time it takes, even in the United States, to train a supervisory professional, the banking supervision staff still does not fully understand the fundamental policies and procedures developed in earlier collaboration with the IMF.

The next two years are critical because the independence of the NBG -- its ability to withstand pressures for political forbearance -- will be tested as rising capital requirements place pressure on banks to consolidate.⁴⁵ The NBG has met this challenge in the past. An allegedly well connected, large private bank, IvertBank, had its license revoked in 1998 and liquidation proceedings commenced. As noted earlier, Memoranda of Understanding were also arranged and monitored with the more important banks after the Russian crisis.

II.2 Regulatory Infrastructure

While the NBG regulations are beginning to conform to Basle international standards, many are not entirely in compliance. Moreover, because of the wording in many regulations banks can find numerous loopholes or other ways to avoid compliance. These critical weaknesses hamper both inspection and enforcement efforts of the BSD. There is also a lack of consistency within the regulations.

An USAID legal advisor from a US bank supervisory agency arrived at the NBG in July 2000. He will work with the NBG to strengthen these weaknesses in the current regulatory structure. The legal improvements and changes will focus on the development and implementation of a new and updated set of regulations that will give the NBG real authority to supervise the banks -- enforcement tools to stop or minimize practices that are detrimental to the banking system.

II.3 ACCOUNTING REFORM, BANK RISK MANAGEMENT AND INTERNAL CONTROLS

Flawed information based on Gosbank accounting methodology limits both more effective bank supervision and more rigorous risk management in the banks. In the area of bank accounting reform, Georgia is decidedly behind many other countries of the former Soviet Union, most of who converted to international accounting standards (IAS) during the late-1990s.

Because of the way accounting is currently done in the commercial banks, the NBG is thus receiving flawed financial information from the banks. The banks, for example, are not using accrual accounting. This can distort bank earnings and overstate profits. The current record keeping practices also allow commercial banks to continue reporting overstated capital positions. This undermines NBG attempts to put the system on a firmer footing by stepwise increases in mandatory minimum capital.

The conversion to IAS in Georgia is scheduled for January 2001. EUTacis has been doing yeoman's work assisting the commercial banks. According to a diagnostic USAID conducted in May, however, banks still are not well prepared for this transition. Perhaps the most important

⁴ The bank supervisory authority will on occasion exercise *regulatory forbearance* when systemic risk is at issue. For example, in the United States during the 1980s LDC debt crisis a "too big to fail" list of banks was issued publicly by the Federal Reserve for which it would provide necessarily liquidity. *Political forbearance* is different. It results from outside pressure and will negatively impact the safety of the banking system.

⁵ A caveat is needed. In the Georgian context, a higher capital requirement will not by itself necessarily lead to a stronger banking system, but could simply lead to the pyramiding of concealed insider loans. Moreover, the prevalence of offshore companies makes it difficult to identify the real owners of the banks.

problem in preparing the banks for the IAS conversion has been the lack of leadership from the National Bank of Georgia in issuing instructions to the banks and answering their questions.

In June 2000 USAID placed an experienced bank and central bank accountant at the NBG to assist the Accountant Methodology Department in efficiently orchestrating the IAS conversion process. Early in 2001, as EUTacis assistance closes, AID will be bringing bank accountants to work with the Georgian banks on specific conversion problems, as well as over time engraining the new methodology in the banks operations.

The mechanical conversion to IAS, however, only initiates the process. The next step is for the bank to make the new accounting methodology the basis for risk management and internal control policies and procedures. An important part of this accounting program too will be the integration of bank accountants into the more general accounting education program, which USAID has been implementing for some time.

II.4 ELECTRONIC FUNDS PAYMENT SYSTEM (E.F.P.S.)

Another critical function of the banking system is the execution of the electronic funds payment system. The ability to affect payments in a timely and efficient manner is as important to the health of the real economy, and the development of a dynamic private business environment as is its funding. USAID's IT Department has been working with both the NBG and individual banks in developing the E.F.P.S., which should be operational before the end of 2000. The F.S.V.C. too is providing substantial assistance, both in training to the NBG staff and commercial banks about usage of the real time gross settlement system, and, in disaster recovery methodology (insulating the E.F.P.S. system from, unforeseen events, such as a power outage).

II.5 BANKERS TRAINING

A final area where the USAID program is concentrated is on bankers training. In Georgia bankers still do not have well developed professional skills given the newness of Western banking. Nor, given the environment, is it realistic to expect them to be schooled in prudential concerns.

The bank training facility, which USAID supported, was founded and capitalized by six of the larger Georgian banks. USAID support began in 1997 and will end in December 2000. The objective from the beginning was institution building — the creation of a self-sustaining banking school capable of offering professional level instruction.

From hindsight it is not clear that this was a reasonable objective, not only because of the short timeframe, but also the limited size of the Georgian banking market. There were also problems in the way the

Contractor delivered the TA. USAID paid local staff salaries at rates considerably above the local market scale, as well as a high rent for the training facility. The founding six banks, which capitalized the training facility, cannot financially maintain this level of monthly expenditures after USAID support is withdrawn.

In late June, at USAID's recommendation, the Contractor sent out a short-term advisor to develop, together with the commercial bank owners of the bankers training academy, both a more realistic financial strategy after USAID's assistance concludes, and to design an upgraded curriculum. Our current thinking is that the banking system in Georgia is probably too small to support a bank training facility by itself. Instead a facility should be developed which services the entire financial community with a perspective of creating a financial sector development institute

within a broader, already self-sustaining, institution so that fixed costs will be minimize and scale economies can accrue.

III. LOOKING AHEAD

As noted earlier, Georgia is a challenging banking environment. The ultimate objectives is a banking sector which performs well the basic functions necessary for economic growth -- mobilizing savings, intermediating between savers and investors, acting as a transmission belt for government monetary policy, and efficiently executing payments. Given the current economic trajectory touched on earlier, it is unlikely that by the end of the Bank Supervision Task Order in early 2002, the situation will be dramatically different.

What could, however, realistically be expected during this time period is a decided improvement in the prudential regulatory environment -- the regulatory framework should by then, not only be largely consistent with international standards, but specifically empower NBG supervisors to carry out their prudential responsibilities. Moreover, a new, rigorous accreditation program will also help raise the professional expertise of the bank supervisors. We should also gradually see improvement in reporting by the banks as the IAS methodology becomes more entrenched.⁶

Improvements in the legal and accounting areas will greatly enhance the NBG's ability to supervise and monitor the commercial banks. A more viable legal and accounting structure will allow the NBG to perform a better financial assessment of the banks and these programs will also circumscribe the banks' ability to hide losses and/or hide behind poorly written laws and regulations.

Thus, by the conclusion of the Bank Supervision Task Order, the BSD should have far greater insight into the actual financial condition of the banking system. Starting in 2001 these improvements should lead to consolidation in the banking system and further reduction in the number of banks. Over the next year too, there should be a solid beginning in developing a sustainable, professional training center that services different facets of the financial community, including banking.

IV. INTEGRATION WITH OTHER PROJECTS

IV.1 CURRENT

There are three areas where coordination has already been established.

IV.1.1 Bank Supervision: The technical assistance to the National Bank of Georgia Bank Supervision Department is a collaborative effort between USAID and the International Monetary Fund's Monetary and Exchange Affairs Department (MAE). USAID has fostered this IMF/MAE collaboration in many other countries of the region over the past six years. While USAID's resident advisors are concentrating on the fundamentals (on-site inspection, off-site analysis, regulatory structure) the IMF advisor is concentrating on the immediate question of bank liquidation. (Of course, these areas greatly overlap, as does the work of the advisors.)

⁶ What we cannot expect in that time frame, however, is the mirroring of NBG risk management procedures in individual banks, the next step -- taking the revamped accounting methodology and using it to upgrade banks' risk management and internal controls and procedures.

IV.1.2 Accounting: Collaboration has begun with EUTacis on implementing conversion of the banking system to international accounting standards (IAS). EUTacis has funded a project to work with individual banks on the IAS conversion. The EU Project will finish in early 2001. Progress has not been rapid to date because the National Bank of Georgia's Accounting Department has not taken an aggressive leadership role (giving instructions to banks and answering the many questions, which arise in testing the new chart of accounts). As noted earlier, USAID has just brought an experienced accountant to work specifically with the NBG. In early 2001 at the conclusion of the EUTacis project, USAID will bring two more accountants to continue the bank specific assistance.

IV.1.3 IT: Lastly is the collaboration with USAID's Information Technology Department (IT) in several areas, including the implementation of an off-site analysis system for the NBG Bank Supervision Department and the development of the electronics funds payments system. The FSVC has brought short-term volunteers to help develop the NBG's disaster recovery plan and instruct commercial banks and the NBG in usage of the real time gross settlements system, working under USAID's IT resident advisor.

IV.2 PROSPECTIVE

IV.1.1 Bank Training: The six founding banks of the Bankers Training School have formed a subcommittee to explore a short-term solution, which would involve the development of a financial services training facility. This would initially involve a merger with capital markets functions which is currently part of a similar USAID training project. However, this strategy would still not lead to a self-sustaining entity after USAID funding is withdrawn. Thus a longer-term strategy is being discussed which would develop a financial services institute within the context of an already well established Georgian University. Any future USAID assistance to the banks in this particular area, after the current task order ends in December 2000, will hinge on the energy with which the banks undertake longer-term planning, rather than continue to depend upon the USAID subsidy.

IV.1.2 Accounting Reform – Professional training: As noted earlier, the USAID programs to assist the NBG in the conversion of banks to IAS is only the first stage in a broader program to upgrade the risk management and internal control systems of the banks. Critical in the first stage of the program is training of professional accountants. This training is a combination of theory and practice - - praxis. A professional is an individual who has both the conceptual background, through extensive classroom or long-distance learning, and the practical hands-on, on-site experience of applying this knowledge. In Georgia, the accounting profession is starting from the beginning because accounting played a different role in the former communist system. There does not exist in Georgia an experienced cadre to mentor younger professionals.

The on-site experience will be developed through the Booz Allen Hamilton task order, which began in June with the placing of an accountant at the NBG. The classroom training will be done in collaboration with Sibley International, which is already implementing the rigorous, British developed training program for business accountants. Discussions are beginning with Sibley on how to integrate the classroom education of bank accountants with the larger program, taking into account the specialized training required for bank accountants (for example methods for loan-loss provisioning).

ANNEX V: Capital Markets

By Anne Richards

REPUBLIC OF GEORGIA CAPITAL MARKETS DEVELOPMENT PROGRAM

I. SUMMARY

The capital markets development project officially began in Georgia on November 1, 1997 with full time residents (Barent's) on the ground in early January 1998. The original project was for two years with a ceiling of \$10.4 million. The original task order was written by Bob Singletary in conjunction with a multi-disciplinary team that sought to look at economic reform in Georgia on a comprehensive basis. Similar projects in accounting reform, fiscal reform, land and enterprise privatization and public education were begun on or about the same time. The contract was extended on a no-cost basis at the end of 1999 with a life to 10/31/00. It's anticipated that we might do a further extension for the sole purpose of providing financial support to certain entities receiving financial assistance.

This revised Task Order has five specific objectives:

- (1) to provide comprehensive development of the GOG's securities regulatory capacity by creating and/or reforming all of the needed legal and institutional components;
- (2) to provide a commercially viable securities trading mechanism that is capable of trading several types of instruments, is open to all qualified brokers, has a high degree of systemic integrity and operates in a transparent fashion;
- (3) to provide a commercially viable independent share registry mechanism, central clearance, settlement and depository system that is capable of serving all of the trading mechanisms in Georgia, has a high degree of systemic integrity and provides equal access to all qualified market intermediaries;
- (4) to increase the level of knowledge of the market intermediaries, other members of the securities community, GOG officials and the general public through extensive training; and
- (5) to promote corporate governance, shareholder participation and compliance with NSC regulations by the newly privatized companies.

A securities law was passed in December 1998 that created an independent securities regulator. A stock exchange with 25+ members was developed in the fall of 1999. A good portion of the infrastructure has been or is being put into place however additional work needs to be accomplished before the securities market in Georgia fulfills its purpose of raising capital to begin new businesses, grow businesses, replace infrastructure, etc. In order to achieve further progress in this regard, this Task Order provides assistance in five interlinked areas.

First, USAID will continue to assist the National Securities Commission ("NSC") in building the regulatory capacity Georgia needs to oversee its markets. The Contractor will continue its efforts to help the NSC set its structure and staffing. Further, the Contractor will be required to continue its efforts to assist the NSC adopt regulations governing the issuance and trading of securities, impose and enforce shareholder rights and other aspects of corporate governance, receive and make available to the public filings of financial statements and other disclosure, set licensing standards for market participants. In addition, the Contractor will work closely with all USAID contractors participating in the economic reform portfolio. This includes contractors involved in the area of accounting reform, fiscal reform, land reform, enterprise

privatization, bank supervision and if applicable, pension reform so that each contractor will be able to leverage off work accomplished by the others.

UPDATE: Following an edict passed by the President of Georgia in 1999 to allow for up to two foreign commissioners on the securities regulator, and a global solicitation orchestrated by the World Bank and funded by AID, two expat commissioners (Robert Singletary and Robert Pardy) took up residence in Tbilisi in March 2000. Technical assistance to the NSC was part of their scope of work but mentoring was deemed to be just as important. I've heard anecdotal evidence that the mentoring has so far been quite successful (and not from one of the expats!) New space has been acquired for the regulator and a process to enforce securities laws has begun. Companies who should be complying are visited, advised to comply and sent letters if they don't. Four letters were sent out recently to companies that had not complied and three of them responded immediately.

Second, USAID will continue to assist in the development of a mechanism for securities trading. Following a competitive process to select the Georgia Stock Exchange ("GSE") as the recipient of assistance from USAID, the GSE in September 1999 held its initial organizational meeting as a Self-Regulatory Organization ("SRO"). The Contractor will continue to assist the GSE in adopting or revising its rules and operating procedures relating to trading, membership, disciplinary procedures and other conduct by members.

UPDATE: The Contractor completed the installation of the selected trading mechanism, the Russian Trading System (RTS) in February, mock trading began shortly thereafter and actual trading began in April with United Bank of Georgia trading 1000 shares in five trades. There are 8 companies that have provided required financial information to the securities regulator and are now available for trading. As companies comply with disclosure requirements, they are being added for trading and it's estimated that between 50 and 70 companies will list by the end of July. Approximately \$1,000,000 worth of stock has traded since trading has begun and I have been assured by those closely involved that there is actual buying and selling occurring.

Third, USAID will continue to assist in the creation and development of a centralized clearance and depository system. As in the exchange area, the Contractor reviewed the available systems, recommended a selection to USAID and will be working with the Georgians to install the selected system (the Romania Depository System). In the meantime, the Contractor has assisted the counterpart in developing a manual system for use prior to the installation of the hardware/software and has assisted the depository in adopting rules and operating procedures relating to clearance, settlement and depository activities, financial responsibility, membership, disciplinary procedures and other member conduct. In order to assure commercial viability as soon as possible, the Contractor has developed a business plan with the centralized clearance and depository system.

UPDATE: The Romania depository system has been chosen but due to operational problems not caused by the Contractor, installation has been delayed. In the meantime, a manual system has been developed and is functioning. In my opinion, it is a positive development to have the market participants learning the functions of clearance and settlement from a manual basis so that they truly understand the different elements of the process. Current volumes of trading do not yet warrant an electronic clearance and settlement.

Fourth, USAID will provide assistance to market professional participants (particularly broker/dealers) and other members of the securities community. The Contractor will provide extensive training to all of these groups on a variety of topics using both lecture and follow-up on the job training. The Contractor will also assist the NSC and the private entities with general

education and public relations vis a vis GOG officials and the general public. This public education aspect will be in conjunction with all other economic reform projects.

UPDATE: Training continues with the broker/dealer association. A proposal has been put forward to enter into an arrangement with the banker training institute in Tbilisi so that efficiencies of scale can be realized from the banker training facility that exists in Tbilisi. Donor funds are probably necessary to make this happen.

Fifth, USAID will provide assistance to the newly-privatized enterprises in order to improve corporate governance, promote shareholder rights and participation, and obtain compliance with the new NSC regulations relating to disclosure and reporting. The Contractor will achieve these goals through a combination of training, on-site assistance and written materials.

UPDATE: A follow-on project is currently (literally right now) being drafted that cross-cuts capital market development and accounting reform. I've been advised that the Contractor, on behalf of an assignment for another AID project in the region, is in the process of writing a white paper on corporate governance, using the example of the Company Law in Georgia as being the crux of the matter. I've encouraged them to make that paper available by the middle of July.

Sixth, USAID will provide assistance to complete the institutional development of the independent share registries. The Contractor will assess the status of the project and recommend additional activities so as to assure the commercial viability of the registries.

UPDATE: The Contractor has completed the assessment of the consolidation process originally begun by the WB and has provided a final report to AID. In summary, of the 394 companies originally included in the consolidation process, as of April 2000, 314 companies have completed the consolidation process, 27 are in process and 35 are in the waiting stage. Eighteen companies remain unaccounted for. In addition there are 47 newly created reported companies that are in the process and 146 companies who would not be required to follow consolidation requirements (less than 100 shareholders) that have elected to do so.

III. BACKGROUND

A. Regulatory Environment.

Georgia's regulatory structure and division of authority and responsibilities as they relate to the financial sector are much like other countries in the region with an emerging market. In general, the major players are the Ministry of Finance ("MOF"), the National Bank of Georgia ("NBG"), and the NSC, now an independent agency but former department of the MOF.

Prior to the development of the NSC the MOF had provided all of the regulation of the non bank financial market and a substantial portion of the banking regulation. In addition, the MOF (through the predecessor to the NSC) had the responsibility to consolidate the share registries of the enterprises privatized by the Ministry of State Property Management ("MSPM"). In addition, the MOF is the sponsor of the various laws that in the U.S. would be referred to as the corporate code, commercial code, and bankruptcy code, the laws affecting foreign investment and the tax regime.

The NBG has provided the remainder of the banking oversight, acting in its role as Central bank. In addition, the NBG is important within the Georgian capital markets due to the

various other roles it plays. First, the NBG will administer the auctions of the government securities. Second, it will conduct open market transactions with the banks involving government securities. Third, it engages in significant currency trading and acts as the clearance and settlement agent for both exchange and off-exchange currency trades. Fourth, it will have responsibility for clearing and settling all trades in government securities and providing depository record keeping. Lastly, it operates or is installing a SWIFT system, a domestic wire system and a X25 communications net.

B. Exchange Operations

Prior to the onset of this activity there were 8 exchanges in Georgia, in varying states of operations and trading various assets. Following a competition to determine which exchange would receive assistance, the Georgia Stock Exchange, which was created by members of the one of the original exchanges, the Caucasian Exchange, became the recipient of USAID assistance. The GSE had its organizational meeting on September 26, 1999 with 27 members in attendance.

C. Securities and Other Instruments Extant.

There are many different types of securities either existing in Georgia or in the process of being created. As the capital markets in Georgia develop, it is important to explore how trading in all these types of assets can be combined into one system.

1. SOE Privatization Shares

The population of SOEs that could be traded in the capital markets is significant. There were approximately 1,230 SOEs classified as medium and large enterprises ("MLEs") that were subject to the MPP program. These were corporatized and offered to the voucher holders. On average 41% of the shares offered were purchased by the bidders; 59% of the shares remain in state hands overseen by MSPM.

Of course, the percentage of shares sold during the MPP to private holders varied by company. Less than 1% of subscriptions was offered to the employees at a 20% discount. Prior to the MPP some stock (less than 3%) was simply given to the employees.

According to the MSPM, 932 of the MLEs have been completely sold and 298 remain unsold. There are 10 MLEs in which the state owns 1-25%. There are 34 MLEs in which the state owns 26-50%. There are 244 MLEs in which the state owns 51-99%. The state continues to own 100% of 10 MLEs. While the numbers might indicate that a sizeable portion of privatization has been accomplished, it is estimated that the remainder of the unsold MLEs has 60% of the value.

The holders of the SOE shares are predominately individuals, but include Georgian companies, the Georgian privatization funds and foreign investment funds. Because the vouchers used in the MPP were tradable for cash, entities in addition to the individual citizens were able to buy them and participate in the auctions. Individuals hold 66.2% of all enterprise shares. Forty-six Georgian companies own 9.9%. The 12 Georgian privatization funds own 5% and 6 foreign investment funds own 19.8%.

2. Shares of Privately-Chartered Enterprises

According to the NSC, the MOF has registered 64 issues of securities by 46 issuers since 1992. These issuers are the privately chartered joint stock companies that are required to register with the MOF and obtain the appropriate license before commencing business.

3. Government Securities

There are two types of sovereign debt extant in Georgia today. These are holdovers from the Soviet era and the initial government of Georgia after the breakup of the USSR. No interest is being paid on the bonds and there is no organized market for their trading.

First, there are "purpose-oriented passive bonds" issued by the ex-USSR government in 1990. Under the March 13, 1992 agreement among the CIS countries, each former member undertook to repay the bonds issued to their respective citizens. In Georgia this amounts to 49,089,800 Russian ruble bonds. Under an August 1, 1996 Order of the MOF the bonds must be re-registered in order to fix the exact amount of the GOG liability and the terms of their repayment.

Second, there are "domestic premium bonds" issued by the early GOG. These were sold from December 1992 through April 1994 denominated in coupons. A par value of five billion is outstanding. Anecdotal evidence is that they will be redeemed for 200,000 Lari.

The GOG has been issuing bills in the amount of 10 million Lari since mid 1997 with the goal of conducting monthly auctions with increasing maturities. This program has had its ups and downs due to budgetary constraints, currency fluctuations and/or allegations of corruption. Under the current rules only domestic commercial banks will be allowed to participate in the auction. No direct foreign bank participation will be permitted, except through bids submitted through correspondent accounts with local banks, and no domestic non-bank broker-dealers will be permitted.

4. Currency

There are three methods for currency trading in Georgia. First, the official exchange rate is determined daily via trading at the TICEX. The NBG, acting as a trader on the TICEX, absorbs excess supply or demand for Lari thereby effectively setting the rate. This is a physical presence auction market. Second, commercial banks also trade off-TICEX in wholesale trading. This is a phone-to-phone market. Third, retail trading is conducted through the Foreign Exchange Bureau ("FXB") a clearinghouse for the large number of street kiosks providing a cash market for small transactions. This is a physical cash movement operation.

The volume breakdown between the retail and wholesale markets underlines the cash nature of the Georgian economy. Data for the last four months of 1996 indicates that the retail volume (FXB trading) was approximately \$5 million per month. Wholesale volume (TICEX and off-TICEX) was \$18 million per month. This means that 28% of all foreign exchange trading was to facilitate the retail cash economy.

Of the total wholesale foreign exchange trading during the last four months of 1996, the NBG was party to 68% of all trades. Because the NBG trades exclusively on the TICEX, this makes it appear that the TICEX is the system of choice. If, however, one removes NBG trading from the volume figures, the market share picture changes significantly. Of the total private party trades performed during the same period, 73% were conducted in the off-TICEX market, i.e. trading over-the-counter between the banks by telephone.

5. Certificates of Deposit

As noted above, the TICEX plans to trade certificates of deposit issued by the various Georgian commercial banks. Like the trading in currency, the TICEX does not intend to guarantee the trades or maintain a guarantee fund. Instead, traders will be required to have sufficient assets in their accounts as of the trade.

6. Municipal Bonds

There are no municipal bonds issued in Georgia. The various levels of government within Georgia are still in the process of delimiting their respective powers, taxation and financing authority among these. In addition, the decisions regarding which property will remain with the municipalities and their ability to encumber it are still being made. However, some groundwork for municipal financing has occurred. The Kutaisi and Tbilisi town councils have both approved initiatives indicating their desire and intent to issue municipal bonds. Also, the MOF has worked out a model statute on the issue and trading of municipal bonds. After it has passed, the local authorities will be enabled to issue debt.

D. Clearance, Settlement, Depositories and Share RegistriesD.

There are currently seven independent share registries in Georgia although the two share registries that received technical assistance from the World Bank under a pilot project are deemed to be far ahead in the business aspects of share registries, which could ultimately impact their chances of reaching commercial viability. Each registry is being provided consolidation software, the consolidation manual of procedures and guidance and advice from the Contractor. There is currently no centralized share registrar or similar integrated depository/registry. An assessment is currently being done to determine what obstacles exist to completing consolidation, the frequency of these obstacles and remedies necessary. Clearly, unless and until the ownership records are consolidated, verified and finalized there can be no systemic integrity to trading these securities.

There is no centralized clearance and settlement system currently in existence in Georgia that serves all of the exchanges. It is envisioned that software previously developed for a similar capital markets project in the region (Romania) will be installed in Georgia for the use of a centralized clearance and settlement system. In the meantime a manual system is being developed for used prior to the installation of the Romania system.

E. Trade Associations

There are two associations that can be expected to have an impact on the development of the securities markets. The first is the Federation of Georgian Professional Accountants and Auditors that was formed officially in March 1996. It has 1300 members in seven branches throughout Georgia. They have been very active and have both received help from and given help to the development community.

The second group is the association of professional market participants, the Georgian Securities Industry Association, formed officially on April 25, 1997.

F. Investment Funds

There are no publicly held investment funds in Georgia. There were 10 privatization or voucher funds created in connection with the mass privatization program. These continue to be regulated by the MSPM.

The privatization funds did not play a large role in the MPP. The funds were able to attract only 4% of the outstanding vouchers in exchange for their shares and therefore they were not able to bid significantly. The general public's lack of interest in buying fund shares with vouchers has been attributed to past scandals involving fraudulent investment funds and pyramid schemes.

ANNEX VI: Commercial Law Reform

Dumas
9/24/99
Commercial law
assessment

Introduction - Scope

The commercial law analysis in this assessment report focuses on the implementation of the commercial law framework, and the constraints that the current commercial law structure imposes on economic growth. This section accordingly focuses on : (a) the preparation and passage of key commercial laws, (b) the implementation and use of those laws and (c) the enforcement of those laws. The principal commercial law categories covered by this analysis include: company law, contract law (also referred to as obligations law), collateral law (personal property), bankruptcy law, trade regime (WTO accession), foreign investment environment, and competition policy. The report does not separately analyze the work being done by each of the various market reform contractors, including in the areas of capital markets, accounting reform, tax and fiscal reform, banking, privatization (including land titling) and energy. However, this assessment report does address these areas, particularly (1) where there are linkages between the reform areas and commercial laws and (2) in identifying issues that are likely to present impediments to economic growth in Georgia and that are accordingly relevant both to investment and the Mission's achievement of its Small and Medium Enterprise objectives.

A. Progress

Georgia has made major progress in enacting the codes and statutes necessary to establish most of its commercial law framework, as well as various statutes supporting USAID's market reform programs. The Civil Code includes articles governing obligations law, collateral law and mortgage law.⁷ Georgia also has a bankruptcy law (the Law on Proceedings in Bankruptcy, company law (Law on Entrepreneurs), anti-monopoly law⁸, securities law, and tax code. Final negotiations governing Georgia's accession to the WTO are scheduled for October 1999; a vote by Parliament is necessary for Georgia to accede thereafter.

Georgia has also enacted various laws governing the operations of the entities which adjudicate and administer its laws. Primary among these are the new Civil Procedure Code, General Administrative Code of Georgia and Code of Administrative Court Procedures of Georgia. The General Administrative Code (the Administrative Code) is particularly important as it is intended to provide greater transparency and due process in, among others, executive branch administrative bodies. As noted in _____ [reference to anticorruption summary], the Administrative Code includes provisions regarding: limits on the exercise of discretionary power; the right of the public to have access to administrative documents (e.g., freedom of information

⁷ The five parts of the Civil Code in their respective order are: General Provisions; Right of Ownership and Other Rights in Rem (which includes provisions on movable and immovable property, including collateral law); Law of Obligation - General Part and Special Part;

⁸ Note to OER - I understand that there is an anti-monopoly law. However, I do not have details about how recently it was prepared nor the source in the international community of technical assistance in its preparation.

provisions); basic process requirements for issuing regulations (also referred to as administrative acts); and basic process requirements for administrative decisions and appeals of those decisions. The Law on the Procedures for the Enforcement of Judgements establishes a Department of Enforcement under the Minister of Justice to enforce judgments of both the courts and administrative officials.

B. Constraints to Implementation of Commercial Law and Economic Growth.

The constraints to the implementation of commercial law and economic growth in Georgia fundamentally demonstrate the linkages between rule of law and economic growth. Such constraints also fundamentally demonstrate the impact that corruption has in reducing economic growth. As discussed in the following section, Georgia has made great progress in the enactment of a commercial law framework. However, the reduction of corruption and the establishment of the rule of law are critical for this framework to be implemented and economic growth to be realized.

Many of the constraints to economic growth in Georgia – particularly with respect to small and medium enterprise growth – have been identified in assessments and analyses previously prepared for USAID/Caucasus. However, a number of themes arose in meetings during this assessment which bear summarizing, particularly as these themes relate to commercial law implementation and enforcement.

Corruption among public servants. Public servant corruption, particularly within the tax inspectorate and customs, was consistently identified as the major problem facing Georgia. This corruption prevents a uniform administration of the laws, provides incentives for the private sector to engage in corrupt practices to obtain favorable results, puts entities which do not participate in corrupt practices at a competitive disadvantage, and prevents transparency and predictability in the public sector. Corrupt practices also threaten Georgia's economic growth. Monies which would otherwise fund government budgets are siphoned into the pockets of public servants. In addition, certain private sector participants also consequently fail to make tax and similar payments.

Public service reform, including adequate compensation for public servants, strong honest leadership, and a mechanism to enforce laws against those taking bribes are all necessary. [Insert reference as appropriate to A-C section.] As an indication of low salaries, the marshalls under the new enforcement service receive an average salary of approximately 18 lari/month. Such salary may be supplemented by up to 1% of proceeds realized under a recent approach developed by the Department of Enforcement, however, such low base salary may nonetheless create incentives for marshalls to demand payments to facilitate services they are required to perform by statute, or for skimming cash proceeds realized. Various Georgian banks state that they routinely must pay to marshalls an additional 2-3% of the value of collateral to be seized in order for marshalls to foreclose upon the collateral.

The tax inspectorate and customs were always identified as the most problematical subsectors in the area of corruption. Almost every interview conducted on the subject of commercial law and business growth began, "The biggest problems are the tax inspectorate and customs."

The absence of strong leadership supporting reforms is a related constraint. There is at least a perception that the defense ministry has prevented the successful enforcement of certain matters that may be adverse to its interests. Similarly, the _____ [name of commission charged with anti-monopoly law] has not proceeded adversely against enterprises connected with senior Georgian officials. State executive branch bodies mentioned as being particularly corrupt (without further

information regarding the nature, level or source of the corrupt practices and influences) include the Ministry of Fuel and Energy and Ministry of Transport.

Despite the recent reforms regarding the judiciary – including the mandatory qualification examinations for judges – businesses remain concerned regarding the potential for judges to engage in corrupt practices. Partners of one prominent Georgian law firm report that judicial corruption is more prevalent outside of Tbilisi.

Over-regulation and overly detailed laws. Georgian policy makers and law makers have a tendency to regulate commercial activity – rather than set rules that will allow business to function within agreed rules of the game. For example, the Law on Entrepreneurs contains detailed provisions requiring that all business correspondence be kept for ten years. Accountants note that Georgia policy makers have not yet shifted to an understanding that accountants are not supporting the government budget process. To quote one Georgian (who spoke in English): “Everything is too detailed. Everything.”

Over-regulation and overly detailed laws make it difficult for businesses to operate, cause businesses to spend additional time and funds determining how to comply with laws, and may create disincentives for entering into business transactions. In addition, over-regulation and overly detailed laws – particularly when combined with the increased likelihood of conflicting legal standards and unclear drafting – create opportunities for corruption. Anecdotes from the business community indicate that tax inspectors are exploiting provisions in the Law on Entrepreneurs and other laws that they reportedly do not have the authority to administer or enforce. Although the new Law on Licensing Activities and Law on Entrepreneurs are important additions to the statutory framework of Georgia, (1) the business registration process still contains numerous processes and requires approvals from various authorities, (2) businesses remain concerned about the numbers of licenses and other permits they may be required to obtain in connection with the ongoing operation of their businesses, and (3) the Law on Entrepreneurs does contain various provisions that are burdensome for businesses to comply with .

Unclear laws and absence of implementing provisions. General complaints were raised about laws being unclear, including as a result of inconsistent terminology. This may be due to an absence of capability to draft laws. In other cases – including with respect to the Civil Code and the Law on Entrepreneurs – it is likely a result of difficulties and errors encountered in the translations of draft laws from German and other foreign languages into Georgian. Persons also generally noted that laws often lack implementing provisions – sometimes referring to Parliamentarians failing to anticipate the processes and other tools that executive branch bodies will require to implement and administer the laws; other times expressing the views that administrative acts (i.e., regulations) from ministries or other implementing measures are needed to provide procedural guidance

Fragmented legislative and executive rule-making process; absence of policy. Particularly with respect to the tax code, there is a fragmented legislative process. In __, over __ amendments [and executive decrees] were issued with respect to the tax code. In some instances, tax code amendments have been viewed as introduced solely to facilitate corrupt practices and transactions. Such a fragmented process suggests an absence of policy consensus, or a failure to honor that policy when personal interests dominate over public responsibilities.

Judicial absence of knowledge of business practices and concepts. Judges note that they lack an understanding of basic business practices. This includes an understanding of such matters as finance and valuation principals, as well as a contextual understanding to understand fields that are entirely new to them, such as bankruptcy. Judges will not be able to apply properly legal standards to factual circumstances if they lack a framework for understanding the underlying

business transaction – including forms of transactions, distinguishing characteristics among those forms, simple accounting concepts, and simple asset valuation standards. These matters will be particularly relevant in judicial determination of damages and bankruptcy cases. Indeed, one judge candidly – and emphatically – stated that he needed to understand basic business concepts and new fields in order to make correct decisions, including to identify weaknesses and inaccuracies in the positions taken by advocates. This is particularly important as anecdotal evidence suggests that commercial cases may presently be increasing on judges’ dockets.⁹

Absence of knowledge about applicable legal standards; timely access to codes and other legal standards. Legal professionals and business persons lack knowledge both of relevant laws and of easy access to those laws. The means by which laws and other legal norms is disseminated is discussed in more detail at _____ [appropriate reference to RoL section]. In order to emphasize the extent to which the public is not aware of enacted laws, a partner in one of the top law firms in Tbilisi was not aware until the assessment team met with him that the Parliament has passed the Administrative Code or the Law on Enforcement. The inability of the assessment team to pin down the status of several commercial law related matters further attests to the difficulty of obtaining information in Georgia – conflicting accounts of the status of several matters and processes inquired about were the norm, even from sophisticated assistance providers. To quote one judge, “We need information, again information”. This speaker stated this in the context of needing both training, as well as in requesting materials that would help courts understand how other courts were making decisions – both correctly and incorrectly.

Obligations Law/Civil Code. As previously noted, the Civil Code contains Georgia’s basic contract law. The Civil Code was prepared with substantial US, Dutch and German assistance, and with GTZ apparently providing significant assistance regarding obligations law. Several Georgian professionals complained generally that the Civil Code generally needs amendments or clarifications. However, no citations were made to obligations law. Due to the poor quality of the currently available English translation of the Civil Code, it is not possible for the assessment team to determine if there are major problem areas in the obligations law.

Collateral law. The most glaring omission in the commercial law framework is the absence of a registry covering collateral. Specifically, the “unified public registry” contemplated by Article 311 of the Civil Code has not been established. Article 311 provides for the establishment of a register for recording the rights of ownership in immovables and rights in other property. The Article specifies “The procedure for arranging the register shall be defined under a separate law.” Pursuant to Article 255, pledges of personal property which are notarized are generally required to be recorded in the public registry.¹⁰

⁹ As the assessment did not review any court statistics regarding caseloads of various courts in order to determine the composition of current caseloads, references to changes in caseloads and compositions of caseloads are purely anecdotal. However, some judges stated that their commercial caseload is increasing. In addition, as an indication of the proportional caseload in one district court (Rustavi), one judge stated that an average indication of the cases the judge has been recently hearing in a month would be: 4 criminal cases; 10 commercial cases; and 15 family and other non-commercial civil cases.

¹⁰ Pledges of personal property are recorded in a number of places, both based on the introductory language to Article 255 (“A pledge of movable things and endorsable securities, where necessary, as well as other non-material property wealth is effectuated under the procedure for the acquisition thereof”). Liens on motor vehicles are recorded with offices of the local police department. Pledges of shares of

There is a unanimous consensus that the establishment of the registry would greatly assist Georgia. This consensus is among lawyers, international assistance providers focusing on land matters, and bankers. Tbilisi based lawyers spoke of contortions in making personal property filings in real property records (both State Land Management Bureau and the Technical Inventory Bureau). In order to complete the statutory scheme, reduce confusion, and establish an institutional body as responsible for maintaining a unified registry, the personal property registry should be established.

The collateral law also may also suffer from deficiencies that will cause confusion and that will limit the attractiveness of lenders using personal property as collateral. Several legal experts, including one well-known Tbilisi lawyer, stated that the collateral law is deficient in not establishing a clear priority scheme among holders of pledges with competing claims on property. The law's disposition provisions also contain various deficiencies which may retard the efficient and transparent disposition of property. For example, _____ [provisions on public notice and minimum price.].

Related to the adequacy of the collateral law is whether the Civil Code adequately governs the intersection of collateral law and mortgage law. Without citing specific provisions, several persons suggested that the Civil Code might be inadequate in this respect. In addition, concerns were expressed regarding whether the mortgage law (and also the property law) also sufficiently addresses immovable property rights (e.g., houses, apartments) with respect to which the owner does not own the underlying land.

Bankruptcy law. The popular view is that bankruptcy law is not understood in Georgia. There have been few bankruptcy cases brought for reasons about which this assessment can speculate based on discussions held. Businessmen and the public may not understand the purposes of bankruptcy and the new law, including the rights and obligations associated with bankruptcy. Directors and managers may fear liability for voluntarily filing cases. The filing of bankruptcy by companies which are state owned is likely to lower the value of the company that the Government of Georgia may otherwise feel will be obtained for that company upon its privatization. In August, President Schevarnadze has criticized the Ministry of State Property Management for not raising sufficient revenues from privatization. Businesspersons and lawyers may not trust the courts and bankruptcy administrators to handle a bankruptcy case honestly and competently – both as a result of the historic corruption among the judiciary and the newness of the process. Workers may fear losing the right to be paid wages and of losing jobs. .

The bankruptcy law itself is generally acknowledged to require various amendments, and some suggest regulations, to clarify unclear provisions and complete various missing concepts. For example, the definition of insolvency – based on the inability of a debtor to perform obligations in a fixed term – is considered vague.¹¹ There is no provision establishing a body to supervise bankruptcy administrators, who [evaluate] the debtor's property and, when directors of legal entities are terminated, reportedly have the authority to enter into agreements on behalf of the debtor. Tax liens are junior in right of payment to unsecured claims. In addition, provisions of the Civil Procedure Code, which generally applies to court proceedings of all courts of general

limited liability companies are apparently registered in company registration records at the court where the LLC's charter documents are registered. Tax code liens are filed on a regional basis in "county offices".

¹¹ This may be particularly troublesome if, as one person suggested, it is a criminal violation under the new Criminal Code for a party not to file a petition with the bankruptcy court when insolvent.

jurisdiction, including bankruptcy cases, may require some amendments so as to not overrule certain specific procedural provisions of the bankruptcy law.

Foreign Investment Environment. Foreign investors in Georgia are uniformly frustrated by the pervasive corruption, complex and unclear tax code, and over-regulation of their businesses (Law on Entrepreneurs and requirements of various licenses). Various types of taxes, and their rate structure, result in a high net tax rate to businesses. Tax inspectors pay numerous visits looking for excuses to extract a bribe in exchange for overlooking alleged violations, including minor violations investors attribute to over-regulation. Investors complain about the ability of the tax inspectorate to freeze their bank accounts (into which certain specified amounts required to form and operate a business entity must be deposited; other accounts are presently protected by bank secrecy laws) and cause the funds to be transferred to the state budget without any requirement of a court hearing. Customs smuggling and customs officials seeking bribes are additional causes of significant complaints.

Competition policy. The assessment team did not conduct heavily focused discussions regarding the adequacy of Georgia's anti-monopoly law governing non-regulated industries. Some sources surmised that Georgia probably has an adequate anti-monopoly law. One of the primary constraints presently associated with the implementation of the law is that the individuals leading the present anti-monopoly commission, who are appointed by the President, lack the will to administer the policy contrary to the interests of high level Georgian officials and those associated with them.

C. Priority Needs

Georgia's commercial law statutory framework has largely been drafted. Georgia now needs to implement that framework. Those charged with administration, adjudication and enforcement of the laws must perform their roles in a consistent and predictable fashion that complies with the statutory framework. The business community must understand the statutory framework and the obligations and benefits it imposes. In several instances – largely involving collateral and bankruptcy law - additional technical assistance will be required to complete the statutory framework, reduce unclear provisions and conflicts in the existing laws, and provide additional provisions that will facilitate the application and enforcement of the law. Improving the investment climate and encouraging small and medium enterprises also require that over-regulation of businesses continues to be reduced. As discussed above, executive decrees, regulations and cases must be distributed promptly and be available to members of the legal community, administering bodies and the public. Recommendations regarding the publication and distribution of such information is set forth in section ____ of this assessment report. [Insert appropriate cross-reference to RoL on transparent legislative process and dissemination of laws, etc.]

The items listed below are critical to the impartial and predictable administration, adjudication and enforcement of Georgia's commercial law and to economic growth. However, it must be emphasized that the most important need for the impartial administration is the reduction of public servant corruption – in the tax administration, customs administration and public administration as a whole. Concomitantly, the reform of Georgia's tax code – to develop a consistent code with a structure that will balance the needs of businesses to enjoy their profits against the need for the state to raise revenues – is essential to Georgia's stability and economic growth.

Completion and Important Refinements of Legislative Framework

1. Registry for personal property; associated analysis and establishment of lien priorities, collateral filing requirements and consideration of whether filing should be required for more security interests in personal property. Increased filings would provide greater protection for lenders and potential business partners by providing public notice of encumbered property. Such filings would also provide a record for notifying those with an interest in property when such property is proposed to be disposed of - whether to satisfy a court decision, in connection with bankruptcy proceedings, and in other circumstances.
2. Bankruptcy amendments (including those providing for supervisory mechanism for bankruptcy administrators), standard forms and outreach. If bankruptcy gains greater acceptance, regulations may be appropriate. There is a group of Georgians who have begun working on amendments and some amendments have reportedly been submitted to Parliament. GTZ has reportedly provided some assistance regarding certain draft amendments to the bankruptcy code, however, it appears that USAID assistance will be appropriate to assist the identification and preparation of amendments.
3. Harmonization of laws; clarification of important existing provisions; and preparation of amendments necessary to implement legislative reforms. Both assessment results and ENI experience establish that some needs exist in this area and will arise over time. This is particularly likely in the case of the Civil Code, due to its breadth in governing many basic commercial transactions. For example, the Civil Code does not recognize electronic communications (etrade confirmations) for valid obligations. This should be an area where a contractor is available to provide assistance as and when needed, in addition to the collateral and bankruptcy areas noted above.

A particular area that will require attention is amendments to the Civil Code, Civil Procedure Code and other laws that will facilitate lenders and others acquiring and liquidating property in an efficient manner. It appears that a useful task will include the contractor - in coordination with Booz/Land Privatization, Booz/Banking, other appropriate assistance providers, and the local banking community (suggest working group here) - assisting in identifying impediments to the acquisition and liquidation of collateral and assisting in the preparation of necessary changes.¹²

4. Tax code regulations.
5. Assistance (as necessary) to cause the government procurement law to satisfy WTO standards, by setting forth provision for international procurements. This work will need to be completed if it is not finished by IRIS prior to 3/00. Anticipated WTO date for effectiveness of such a law is 12/31/00. [OER to confirm with Al Shinn/IRIS nature of work that needs to be done]
6. [See Insert A]

¹² Note to OER: Following Bob Cemovich's return to Tbilisi, Missin should discuss with Booz the extent to which Booz is: providing assistance regarding mortgage law; assisting the strengthening of the land bureaus to help them establish and maintain filings systems, including procedures regarding the filing of mortgage documents; and responsible for considering the legislative framework associated with mortgage foreclosure.

Increased transparency and efficiency/institution building assistance

1. Institutional strengthening associated with bodies who implement and administer laws – particularly, collateral registry, company registries. This includes TA to the body responsible for the registry to support the establishment of a filing system and procedures for its transparent and efficient operation.
2. Implementation of Administrative Code. [Insert reference to AC text on Administrative Code implementation]. In the case of the executive bodies who are significant counterparts to OER's reform activities, the respective contractors under these activities should be able to provide technical assistance in this area. For example, Barents/Tax and Fiscal and Barents/Capital Markets can assist the tax and securities administrations in establishing procedures that comply with the applicable provisions of the Administrative Code. Due to the progress of Barents/Capital Markets to date in assisting to establish the securities exchange, on which trading is anticipated to commence before 12/31/99, this may require minor additional assistance by Barents/Capital Markets.

Business community and public awareness of reforms.

Public awareness of reforms, especially to business community. The public, and businesses in particular, need to understand commercial laws, including the rights and obligations that they impose. Public outreach efforts to businesses regarding reforms should contain practical and specific information regarding reforms and emphasize, where possible, expected benefits to business from the reforms. [Query need of DG to provide media with some training regarding financial matters, bankruptcy, etc.]

Professional strengthening through training and reference materials

1. Judges, who are charged with interpreting laws and adjudicating matters, must understand the new laws in order to apply them properly to specific factual cases. Trainings should include useful hand-outs to assist judges until commentaries and manuals¹³ are available. This is particularly important as there are a limited number of experts in Georgia who have knowledge of the new laws to prepare commentaries and manuals.¹⁴ Although the World Bank and EU/TACIS plan to support the Judicial Training Center in its development and delivery of curricula, it is unlikely that their assistance will extend to all priority commercial law areas. Particularly important subject areas that will not be covered by any modules generally covering the civil code include: bankruptcy, the Law on Entrepreneurs, the securities law, tax law, banking law, the Administrative Code and the _____. [OER – please add additional areas of particular concern.] Judges will need to understand collateral law, bankruptcy law, foreclosure law and applicable provisions of the Civil Procedure Code, all as they relate to the execution of decisions to acquire and/or liquidate real and personal property.
2. Advocates, jurist consultants (similar to in-house counsel), notaries, bankruptcy administrators, and marshalls will also require training in commercial law. In particular, marshalls will need training in collateral law, bankruptcy law, foreclosure law and applicable

¹³ As used in this assessment, and as apparently referred to in Georgia, "manuals" include practical instruction regarding how the law is intended to apply to particular situations.

¹⁴ According to Amex, the preparation of commentaries in its work plan – specialized obligations and licensing law – have been delayed to the death of the Georgian experts working on those commentaries and the difficulty in finding experts to continue the work.

provisions of the Civil Procedure Code, all as they relate to the execution of decisions to acquire and/or liquidate real and personal property. The World Bank and/or GTZ may be providing assistance in training marshalls on certain topics. Notaries, among other things, determine that contracts to be notarized comply with law. As they have a legal education, they can be included in various training programs with lawyers.

3. Legal professionals, particularly judges and lawyers, require commentaries, manuals and other source materials to understand the law and obtain guidance regarding its application. Support should be provided for the preparation and distribution of the following secondary source materials.

- Law on Entrepreneurs – manual to supplement the existing commentary
- Tax Code – commentary or manual
- Securities law – commentary or manual
- Banking law – commentary or manual
- Civil code – manuals on property, general obligations and special obligations.

In addition, to the extent that Amex does not complete the preparation of commentaries and other materials which it is scheduled to complete prior to the expiration of its contract, especially the bankruptcy practitioners guide, support for the preparation of such materials will need to continue.¹⁵

D. Recommendations

1. Primary Activities

Reference to items noted above under Priority Needs.

2. Quick starts.

Items marked with an asterisk do not require any additional funding or contract vehicle.

- * AmCham and Barents/Tax & Fiscal are cooperating in Barents' review of the tax code.
- * Barents/Capital Markets (per Jonathon Bulkey) will be contacting AmCham to discuss AmCham concerns regarding specific provisions of the Law on Entrepreneurs.
- * As part of its public outreach work, Barents/Tax and Fiscal can conduct public information effort regarding taxpayers' procedural rights regarding the freezing and transferring of funds on deposit in bank accounts. For example, it appears based on advice from Barents/Tax and Fiscal that (1) a taxpayer should receive a collection order before funds can be transferred and (2) the taxpayer has the right to appeal the notice (initially within the tax administration) prior to the transfer of funds. Barents/Tax and Fiscal will need to coordinate with the new Booz/Banking project to determine the extent to which banks face fines or are under other pressure to approve quickly funds transfers.
- Initial judicial training on basic business practices. Combine forms of business organization (law on entrepreneurs), types of transactions, some accounting.
- * Add EG member to ACWG [insert reference to AC section of assessment]
- * Bankruptcy assistance: Assistance with preparation of amendments, building on Amex's recent work regarding bankruptcy. [Note: should (1) determine if bankruptcy code reform is likely to be a significant priority prior to Presidential elections and (2) absorptive

¹⁵ Note to Mission: (A) I assume that RoL plans that the new activity will include the commentary on the specialized obligations on the Civil Code. (B) There may be additional areas for which commentaries and manuals will be useful, including (1) procurement and (2) intellectual property. I understand that GYLA may be preparing a commentary on intellectual property but this has not been confirmed.

- capacity of Amex to perform this work]. The assistance should incorporate relevant suggestions of the short term (approximately one month) bankruptcy expert who will be reviewing the voluntary liquidation procedures under the bankruptcy law as part of OER's privatization assistance.
- Collateral registry design and collateral law assessment: Short term technical assistance (one month LOE?) to provide design suggests for the unified registry. The consultant would, among other things, (a) determine possible institutional bodies where the registry might be based, (b) assess current filing requirements for liens on movable and immovable property, (c) determine major areas of collateral, mortgage and bankruptcy law that may need revision to clarify and establish the rights of competing lienholders, and (d) initially identify process requirements (e.g, adequacy of notice of disposition, sales price floors) that may limit the efficient disposition of collateral. Part (c) would also include an analysis regarding whether current law adequately deals with the rights regarding immovable property where the rights are separate from the ownership of the underlying land.¹⁶ One vehicle for this technical assistance may be a tier one contract under SEGIR LIR.
 - * [See Insert B]
 - * OER review of Amex English language translation of Civil Code to be completed prior to expiration of Amex's contract, do determine that the translation can be used by foreign investors

3. Additional Activities to be included in program design

- Leasing law – The GoG has not demonstrated to date interest in legislation governing financing leases. It is not clear that the business community has a particular interest in a financing lease law. However, assistance may be appropriate where there is political will and identification of what the particular products likely to be provided under finance leasing are. [See Insert C]
- Franchise law – Same points as leasing law [See Insert D]
- Training arbitrators who will conduct arbitration proceedings under the arbitration subsidiary being established under the Barents/Capital Markets project to hear securities-related disputes. This training is reportedly not included in Barents' project.

4. Recommended vehicle

- Comprehensive RoL/Commercial Law/AC SOW
- Discrete activities that can be handled as part of existing OER programs
 - Barents/Tax & Fiscal and Barents/Capital Markets to provide advice regarding regulations for tax administration department and securities function regarding to establish procedures and practices satisfying the requirements of the Administrative Code.
 - Barents/Tax & Fiscal, through modification to its current task orders and increased funding, to assist the preparation of tax code regulations (unless USAID/Caucasus management experience determines otherwise)

5. Additional item outside program design. [See Insert E]

¹⁶ Note to OER: Prior to finalizing a scope for this activity, Mission should discuss with Bob Cemovich the extent to which Booz has focused on, or is responsible for focusing on, immovable rights that are separate from the underlying land.

IMPORTANT: The SOW must be flexible, particularly as (1) the future political climate is uncertain, and (2) one cannot predict where opportunities to assist the implementation

Supplement to commercial law assessment

Insert A

- Simplification (ongoing) of business regulation: registration/licensing/other. Will need to fit with SME assistance. In effect, the SOW can provide legislative technical assistance, as and when necessary to complement the new SME activity. Depending on whether SME priority, could assist in developing central registry of information regarding business registration as all registrations are currently at local and regional courts where the business is based. (International Chamber of Commerce has also proposed centralizing the business registration registry)

Insert B

* Leverage onto SME initial meetings for business outreach and to identify priority concerns. [This provides a way to jump-start onto important demand areas that may require additional technical assistance.]

Insert C

The new SME activity may be used to gauge SME demand for additional legislation in this issue, including to provide in the statutory framework for leases and financing leases

Insert D

The new SME activity may be used to gauge SME demand for additional legislation in this area.

Insert E

The Mission may wish to include in the new SME activity, or otherwise procure, an analysis of court filing fees, enforcement fees and notary structure to gauge their potential for deterring on SME growth. This may be appropriate to include in new SME activity

Suggested Approach to Strengthening Georgia's Agricultural and Agribusiness Market/Value Chain

